EFFECTS OF ECONOMIC POLICY ON SMALL BUSINESS

HEARING

BEFORE THE

SUBCOMMITTEE ON SBA AND SBIC AUTHORITY,
MINORITY ENTERPRISE AND GENERAL
SMALL BUSINESS PROBLEMS

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

SECOND SESSION

WASHINGTON, D.C., MARCH 1, 1984

Printed for the use of the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE
33-786 O WASHINGTON : 1984

H721-16

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EFFECTS OF ECONOMIC POLICY ON SMALL BUSINESS

THURSDAY, MARCH 1, 1984

House of Representatives, Subcommittee on SBA and SBIC Authority, Minority Enterprise and General Small Business Problems, Committee on Small Business,

Washington, D.C.

The subcommittee met, pursuant to notice, at 10:04 a.m., in room 2359-A, Rayburn House Office Building, Hon. Parren J. Mitchell (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN MITCHELL

Mr. Mitchell. Good morning to all of you today. Our Subcommittee on SBA and SBIC Authority, Minority Enterprise and General Small Business Problems will examine the effects of the administration's past and current economic policies on small business.

The committee would like the answers to the following questions for this is the purpose of this hearing: How have small businesses fared over the past few years; what are their prospects under the economic policies outlined in the President's fiscal year 1985 budget; and are there alternative economic policies that would be more beneficial to small firms?

I have a full opening statement, which I will not present in its entirety. I would ask unanimous consent that my statement be submitted for the record. Hearing no objection, the unanimous consent request is granted.

These issues encompassed in the questions that I just posed are of critical importance to the Nation because of the central role that small business will play in the creation of new products and in the generation of new jobs in the 1980's and beyond.

Quite frankly, I am deeply concerned that our economy will not be able to generate enough new jobs in the coming decades. I am very much concerned about that. The rate of job generation has fallen by one-half since the late 1970's. This means that 5 to 6 million fewer jobs will be created from 1981 through 1984 than in the previous 4 years.

I don't think it is any great secret that I have a particular and special and ongoing interest in minority owned businesses. When the small business sector is threatened by an adverse economic climate, the minority small business sector is uniquely imperiled. We must—and this ought to be an enormously high priority for this

Nation—create an economic environment in which minority firms can grow and prosper, an environment that makes it possible for thousands of minority business persons to share in the American dream.

There is a recovery of some sorts taking place. However, the best I can say about the recovery is that it has been uneven. A record number of small businesses failed in 1983. In fact, more businesses have failed in the past 3 years than in any 3-year period since the early 1930's. Small business failures continue at rates above normal postwar levels.

I would call your attention to the chart over to my right, the business failures from 1949 to 1983. That chart demonstrates that the failure rate last year for small businesses was the second highest rate that we have ever experienced in this Nation. The highest rate came in 1932, I believe when the failure rate was in excess of 31,000.

In addition, real interest rates on small business loans remain near the record level set in 1982. On short-term loans, small businesses are paying 8 to 11 percentage points above the rate of inflation. In the post-World War II period, real interest rates for small businesses averaged about 3 percentage points above inflation. A continuation of real interest rates of this magnitude—8 to 11 percent—is likely to have serious detrimental effects on the welfare of small businesses and on the ability of small businesses to generate new jobs for the 1980's and beyond.

I don't want to sound like doom and gloom this morning, but I think we need to lay out the record. In addition to the difficulties I have just mentioned, the recent sharp rise of the American dollar has had a negative impact on small businesses. The subsequent fall in agricultural exports has not only harmed farmers, but also thousands of small businesses. In addition, the record is clear on this point, the overvalued dollar has meant that small manufacturers face stiff competition from artificially cheap imported goods.

All the Members of Congress and the Senate have recently heard from many sources, including officials in the administration, that the huge budget deficits will cause serious economic problems in the near future. The committee has asked a number of witnesses to come here today to evaluate the potential effects of the deficits on small business and to propose solutions for some of these pressing problems.

Let me restate the three areas we want to probe today. How have small businesses fared over the past few years? What are their prospects under the policies outlined in the President's budget? What alternative policies are most likely to benefit the small business community?

[Chairman Mitchell's full prepared statement follows:]

PREPARED STATEMENT OF HON. PARREN J. MITCHELL, CHAIRMAN, SUBCOMMITTEE ON SBA AND SBIC AUTHORITY, MINORITY ENTERPRISE, AND GENERAL SMALL BUSINESS PROBLEMS

Good morning ladies and gentlemen. Today the Subcommittee on SBA and SBIC Authority, Minority Enterprise and General Small Business Problems of the House Small Business Committee will examine the effects of the administration's past and current economic policies on small business.

The committee would like to answer the following questions in this hearing: How have small businesses fared over the past few years? What are their prospects under the economic policies outlined in the President's budget? Are there alternative economic policies that would be more beneficial to small firms?

These issues are of critical importance to the nation because of the central role small business will play in the creation of new products and in the generation of new jobs in the 1980's and beyond. No longer are the giants of manufacturing and mining providing the millions of jobs necessary to employ our youth. Stiff foreign competition and technological advances are reducing employment in many of our basic manufacturing and mining industries. State and local governments provided millions of new jobs in the postwar decades in order to meet the growing demand for public services. Declining school enrollment and other factors are now limiting the growth of jobs in the public sector. As a consequence, the burden of generating millions of new jobs in the 1980's and beyond falls disproportionately on the small business sector. In order to facilitate the job generation process, we must create an economic environment in which small businesses can flourish.

I am deeply concerned that our economy will not be able to generate enough new jobs in the coming decades. The rate of job generation has fallen by one-half since the late 70's. This means that five to six million fewer jobs will be created from 1981 through 1984 than in the previous four years.

I also have a special interest in minority owned small businesses. When the small business sector is threatened by an adverse economic climate, the minority small business sector is uniquely imperiled. Even though minorities comprise 20 percent of all Americans, little more than one-half of one percent of total business receipts are generated by minority small businesses. We must create an economic environment in which minority firms can grow and prosper, an environment that makes it possible for thousands of minority business men and women to share in the American dream.

Although the economic recovery started in late 1982, the recovery has been uneven. A record number of small businesses failed in 1983. In fact, more businesses have failed in the past three years than in any three year period since the early 1930's. Business failures continue at rates far above normal postwar levels. Business failures of this magnitude are a symptom of serious economic problems. The fifty year high in the number of failures is particularly significant in light of the fact that we achieved a thirty-year low in 1978. In the span of a few years we've swung from the best record to the worst.

Moreover, real interest rates on small business loans remain near the record set in 1982. On short-term bank loans, small businesses are paying 8 to 11 percentage points above the rate of inflation. In the post World War II period, real interest rates for small businesses averaged about 3 percentage points above inflation. A continuation of real interest rates of this magnitude—8 to 11 percent—is likely to have serious detrimental effects on the welfare of small businesses and on their ability to generate new jobs for the 1980's and beyond.

Furthermore, the recent, sharp rise in the value of the dollar has had negative effects on small businesses. The subsequent fall in agricultural exports has not only harmed family farmers, but also the thousands of small businesses in rural America that serve farmers. In addition, the overvalued dollar has meant that small manufacturers face stiff competition from artificially cheap imported goods. Moreover, the trade deficits resulting from the overvalued dollar slow U.S. economic growth and further hinder the ability of small businesses to grow and generate jobs.

We have heard recently from many sources, including officials within the administration, that the huge budget deficits will cause serious economic problems in the near future. I have asked a number of witnesses to evaluate the potential effects of the deficits on small businesses and to propose solutions for some of these pressing problems.

These are the questions then. How have small businesses fared over the past few years? What are their prospects under the policies outlined in the president's budget? What alternative polices are most likely to benefit the small business community?

To answer these questions, we have invited a talented group of experienced businessmen and specialists in finance and economics.

[Employment, foreign trade, interest rates, and business failure tables may be found in appendix, p. 195.]

Mr. MITCHELL. We have a number of members of the committee present with us. I would ask if our ranking minority member has an opening statement.

OPENING STATEMENT OF HON. HAL DAUB, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEBRASKA

Mr. DAUB. Mr. Chairman, thank you. I do have a statement, and a very brief one, simply to say good morning to you, ladies and gentlemen.

Thank you, Mr. Chairman. I want to commend you for holding these hearings. I think that the word "deficit" has captivated the imagination of the American people. It is going to be a great debate in 1984 and, indeed, the impact of that deficit, I agree, has a significant relationship with interest rates and, in fact, affects the health and opportunity for our small business community.

I wholeheartedly agree with the chairman, that small business will play a very important role in the job creation process during the 1980's. Small business is the major producer of new jobs in our economy and, therefore, a good indicator of employment trends. I look forward to the hearings and hearing from our distinguished panel of witnesses this morning, on any recommendations that they may have on ways to improve the climate for our Nation's small business.

Thank you, Mr. Chairman.

Mr. MITCHELL. Thank you, Mr. Daub.

Congressman Hayes?

OPENING STATEMENT OF HON. CHARLES A. HAYES, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr. HAYES. Mr. Chairman, I don't want to delay getting into the testimony that we're going to hear this morning. I think it is a critical problem. I also want to commend you, for setting up the hearings so we can get information.

I just heard over the radio yesterday that small business is actually big business when it comes to jobs for people. The question of unemployment, despite what this administration says, is critical in many areas, particularly in my district in Illinois. In Chicago the unemployment rate is still around 20 percent. Most of the jobs come from small business because there is no big business industry in the First Congressional District in Chicago.

Mr. MITCHELL. Thank you, very much.

Congressman Boehlert?

OPENING STATEMENT OF HON. SHERWOOD L. BOEHLERT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. BOEHLERT. Thank you, Mr. Chairman.

I am glad in your opening statement you mentioned that you do not wish to emphasize doom and gloom because I think that's very appropriate. There is a new operative word in America, and I think it's confidence. I think big business, small business, and the American people in general are more confident about the future than they have been at any time in the recent past. I welcome these hearings so that the people who are testifying before this committee can share with us their thoughts on what we can do to make bright prospects for the future even brighter.

Mr. **Mitchell**. Thank you.

Congressman Molinari.

OPENING STATEMENT OF HON. GUY V. MOLINARI, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. **Molinari**. Thank you, Mr. Chairman.

I had occasion to look at your press release this morning announcing the hearing, and I don't know that I agree with a number of the conclusions. But some of us went on a trip—Ed Towns and myself and Congressman Torres—to see Norfolk, the construction of ships, particularly how it affected the small business community. Indeed, since then, I have received a number of communications from the military and contractors, larger contractors, looking for competition in competitive bids from the small business communities throughout the country.

I think if we are going to look at this picture, we should look at it from a broad perspective, both sides of the issue, and to see, those of us who believe that the buildup of the military was something that was vitally necessary and at the same time whether it might have had some beneficial impact upon the people we're talking about here today, the small businessmen.

Thank you, sir.

Mr. **Mitchell**. Thank you.

Congressman Neal Smith, the former chairman of the full Small Business Committee, has arrived. Do you have a statement you would like to make?

Mr. **Neal Smith**. No, I don't, Mr. Chairman. Thank you.

Mr. **Mitchell**. Gentlemen, thank you very much for being here. I always feel enormously guilty in asking people to come to testify. One hour away from your shop and you get a week behind in your work, or at least I do. I know it is a great sacrifice for you to come here and I know I speak for all the members of the subcommittee when I indicate that we are, indeed, profoundly grateful to you.

Our first group will consist of Dr. Donald Straszheim, the vice president of U.S. Services, Wharton Econometrics Forecasting Associates; Dr. Harold Black, professor of finance, Howard University; Dr. C. Fred Bergsten, director, Institute for International Economics; and Dr. Leon Taub, vice president and director of policy analysis, Chase Econometrics.

Gentlemen, thank you. I am a successful politician, having been elected to office on a number of occasions, so I would not dare suggest the order in which you present your testimony. You decide that. Why don't you lead off for us.

TESTIMONY OF DONALD H. STRASZHEIM, VICE PRESIDENT, U.S. SERVICES, WHARTON ECONOMETRIC FORECASTING ASSOCIATES, INC.

Mr. **Straszheim**. Thank you, Mr. Chairman.

I am pleased to have an opportunity to appear before this committee and to discuss economic conditions and prospects for small business in the context of economic policy.

I have a written statement for the record, which I would like to submit, rather than going through that in detail. I would like to just amplify on a few of those points here this morning.

Mr. MITCHELL. Without objection, your entire statement will be submitted for the record.

Mr. STRASZHEIM. Thank you, Mr. Chairman.

Small business will fare only as well as does the overall economy. Small business has been where the growth has been in the economy in recent years. It hasn't been in large manufacturing. Small business needs are somewhat unique, but not all that unique. Small business needs credit; small business needs low interest rates, small business needs stable growth; small business needs rising employment, and generally prosperous conditions. There should be no real surprise in that.

The situation with respect to the budget deficit in the coming years is one which is of particular concern to the economy at large and to small business in particular. We had very large deficits in 1983 and 1984. Those deficits, on the order of magnitude of $200 billion this year, are part of the reason for the solid recovery. A substantial amount of fiscal stimulus was applied.

Normally during recessions, private sector credit demands fall and public sector credit demands rise in complimentary ways. Tax receipts actually fall or increase more slowly, and entitlements payments for unemployment compensation are required to rise, and so forth. In total, during a recession, public sector credit demands rise less than private sector credit demands fall. As a consequence, you normally see a decline in total credit demands and lower interest rates.

The reverse is normally the case during expansion. Private sector credit demands rise in order to finance housing, inventories, nonresidential fixed investment, consumer durable goods, and the like, and similarly, public sector credit demands fall as the tax throwoff from the expansion rises, as unemployment compensation spending declines, and so forth, such that total credit demands rise during recoveries.

Now, the recovery which we confront at the present looks somewhat different to us. The difference is an important one. In this recovery, we see the public sector credit demands still staying very high, while private sector credit demands rise as well. In a word, Mr. Chairman, I think that is where the rub is on the recovery and on the economy in the next couple of years. 1984 is going to be a good year, but in 1985 and beyond the economy faces serious problems. They are related, in part, to these unprecedented and continuing large Federal deficits. Growing tension in the credit markets will result, and that will cause trouble in the cyclically credit-sensitive sectors of the economy. The deficit situation has deteriorated a great deal in the last 2 years, and further budget disappointments we feel are on the horizon.

Routinely, I should add, also, in the past, economic assumptions which are embedded in presidential budget submissions have proven to be overly optimistic. The Wharton current baseline forecast suggests that this will again be the case.

Now let me say something about the deteriorating budget situation. There are three major reasons why the deficit situation has deteriorated in recent years. First, of course, is simply the severity of the 1981-82 recession; second, the 1981 Economic Recovery Tax Act sharply reduced tax bills for both individuals and corporations; and third, on the outlay side, a major buildup in defense spending was put in place, a build up which I should add actually began in the late 1970's. As a consequence, Wharton's view is that the budget problem which had formerly been a difficult but primarily cyclical one is now a chronic one. This problem is, I think, widely recognized. That's what all the attention is being paid to in this town. That view is not unique to us. Indeed, the Wharton baseline forecast anticipates a fiscal 1986 deficit not still in the $180 billion range, but rather, rising to well over $200 billion.

Now let me say something about the budget disappointments which have occurred year after year. I commend to you table 1 in my written statement, which shows that actual Federal budget outcomes for years have shown deficits that come out larger than was originally submitted in the budget. There are three major reasons why these outcomes have usually turned out to be less optimistic than was originally submitted. Again, these are not new problems.

First, tax receipts simply come in lower because tax increases which had been anticipated do not get enacted, or other tax reductions are enacted which reduce revenues.

Second, programed spending cuts which may have been anticipated do not occur and/or other spending increases that are not included in the budget are incurred for one reason or another.

Third, and perhaps most important, the economic assumptions which underlie the budget may prove to be overly optimistic, yielding less revenues and higher outlays.

I commend to you table 2 in my handout which suggests that under Presidents, year after year, we have ended up with actual economic performance falling short of what had been anticipated. This problem is especially severe in the outyears in which real growth has routinely fallen far short. I should point out this is not a new problem, this is not a partisan problem; this has existed for many years.

In table 3 in my written testimony I show the economic assumptions which are embedded in the budget which was just submitted by the President. Those budget estimates again show an economy experiencing very rapid growth in years 1984 through 1989. There is precedent for many years of rapid economic growth. That precedent is in the early 1960's. Conditions now are very different from conditions at that time. In the early 1960's, during that period of rapid economic expansion, the inflation rate started low and it increased rapidly. Interest rates increased as well. Those are quite normal accompaniments to an economy which closes on full employment.

In the 1984 through 1989 period, in our view, if growth were to be as rapid as this, we would not expect that growth to be accompanied by a decline in the GNP price deflator or by a similar decline in the interest rates, as are shown in table 3.

Our baseline outlook, Mr. Chairman, shows the economy growing substantially in 1984, much less so in 1985, and falling to a fractional growth rate in 1986. That scenario assumes no major tax or spending actions enacted in 1984, and a summary of that outlook is shown in table 4. That shows, as well, an increase in the deficit to $213 billion in fiscal 1986.

The strongest growth in the current cyclical period, we believe, is now behind us, and the natural movement of the economy will be toward slower growth, higher inflation, and higher interest rates. We have, accordingly, simulated the Wharton model for an exercise that changes the mix between fiscal and monetary policy and does so late in 1984. The results of that exercise are shown in table 5, and it is constructive to compare table 5 in some respects with table 4, which is our baseline assumption.

The guiding assumption in this policy accord alternative is that the budget outlook is so widely regarded as unsatisfactory that remedial action is taken during 1984. That action is for an increase in individual taxes, an increase in corporate taxes, further steps in 1986 in terms of tax increases, similarly reductions in defense spending and in nondefense spending in 1985 and 1986. It would be our expectation that with those moves there would be a decline in interest rates, as monetary policy would be eased. The weaker economy which those contractionary measures brought forward would further lead to somewhat lower interest rates. Later on in the period, however, the lower interest rates would stimulate demand in the interest rate credit-sensitive sectors of the economy—housing, investment spending, and the like. It would be our expectation that these measures would tend to push the dollar down somewhat more than in our baseline assumption. In general, while the economy would be weakened in the very early stages of this action, the credit-sensitive sectors would more than make up for that later, such that you would get a stronger economy on into 1986. In 1986, in this exercise, we end up with a deficit of something like $86 billion, substantially below our baseline assumptions.

In closing, Mr. Chairman, let me just say that we see the 1985 and 1986 deficits as troublesome, indeed, and the tradeoff we believe in terms of policy is essentially as follows:

The earlier that fiscal restraint would be applied, the less would be the risks to the economy. Conversely, the later that fiscal restraint would be applied, when the economy has already experienced higher interest rates and higher inflation and is already slowing more of its own accord, the greater would be the risk that another major recession would result.

In many respects, what small business needs is the same thing that big business needs, and that consumers all over need, and that is solid economic conditions in general. In many respects, the fortunes of small business will, indeed, take care of themselves if and only if macroeconomic conditions in general are sound.

Thank you, Mr. Chairman.

[Mr. Straszheim's prepared statement follows:]

PREPARED STATEMENT OF DONALD H. STRASZHEIM, VICE PRESIDENT, U.S. SERVICES, WHARTON ECONOMETRIC FORECASTING ASSOCIATES, INC.

The economy, after hitting bottom in December 1982, is now well over a year into a solid recovery. 1984 will be a good year, with rapid economic growth, declining unemployment, and low and relatively stable inflation. However, in 1985 and beyond, the economy faces major problems related in part to the unprecedented situation of federal deficits in the $200 billion range for years to come. Growing tension in the credit markets and difficulties for the cyclical credit-sensitive sectors of the economy will result. The deficit situation has deteriorated substantially in recent years, and if the past is any guide, further budget disappointments are on the horizon. Routinely in years past, economic assumptions embedded in presidential budget submissions have proven to be overly optimistic. The present Wharton baseline suggests that this will be the case again in the coming years. The possible solutions to the budget problem are well known; the only question is choosing. This less-than-satisfactory economic outlook has led to a simulation of the Wharton model with a different set of policy assumptions, a simulation which is discussed below.

THE DETERIORATING DEFICIT SITUATION

The $195.4 billion unified budget deficit in fiscal 1983 was 6.1 percent of GNP, up from $110.7 billion or 3.6 percent of GNP in 1982 and $52.6 billion or 1.9 percent of GNP in 1981. The 1983 figure also compares unfavorably to the prior postwar record of 4.0 percent of GNP recorded in 1975. While fiscal 1983 was predominately a recovery year, the size of the deficit increase from 1982 to 1983 is entirely without precedent. There are three main reasons why the deficit is, and will remain, so large over the next few years.

First, the severity of the 1981-82 recession following so closely on the heels of the short but sharp 1980 recession is a major contributor. The result was an unemployment rate that reached a postwar record, capacity utilization which fell to its lowest level in 40 years and generally the worst conditions with respect to economic activity in decades. As a consequence, the workings of the automatic stabilizers reduced the tax take and greatly increased automatic entitlements and payments. These budget characteristics were entirely predictable.

Second, the 1981 Economic Recovery Tax Act substantially reduced tax receipts further over three years. In particular, the 5-10-10 individual income tax reduction and the 15-10-5-3 Accelerated Cost Recovery System sharply reduced tax liabilities for both individuals and corporations from what they otherwise would have been. The 1981 legislation was enacted during a year in which the inflation rate was approaching 10%, and the individual tax reduction was widely regarded as essentially an offset to the "bracket" effect of higher tax liabilities resulting from the intersection of rising nominal incomes and a progressive tax code. In retrospect, with the sharp decline in the inflation rate, it is clear that the 5-10-10 measure substantially reduced real per capita individual income tax liabilities.

Third, on the outlays side of the budget, a major buildup of defense spending which actually had begun in the late 1970s was accelerated another notch. In addition, transfer payments have been increasing rapidly and net interest costs have mounted along with the national debt.

The joint consequences of tax cuts and spending increases on top of a major low cyclical starting point is a deficit that is structurally far from balance. The budget deficit problem, formerly cyclical, has now become chronic. The Wharton forecast reflects this condition. While the administration's budget deficit stays in the vicinity of $180 billion for the next four fiscal years, the Wharton baseline forecast anticipates a fiscal 1986 deficit rising to $213 billion.

BUDGET FINANCING AND CREDIT NEEDS

The budget affects the economy and the economy affects the budget. Usually during recessions, tax revenues fall as a consequence of weaker economic activity, and entitlements payments rise as a result of higher unemployment. Together the public sector's demands for credit rises as the economy weakens. The private-sector's demands for credit work just in reverse. In recession, private credit needs fall as does economic activity.

During recovery, credit needs work in the reverse fashion. Stronger economic activity leads to increased tax receipts, less unemployment compensation spending, and a fall in public sector credit needs. In the private sector, credit requirements rise in order to finance larger inventories, consumer demands for credit, housing finance, capital spending and the like.

This complementary relationship is part of modern fiscal thinking. However, that relationship will be substantially compromised in the coming years. As the economy recovers, in Wharton's baseline, private-sector demands for credit will rise, yet public-sector demands for credit will stay large rather than falling substantially. This is the well-known public- and private-sector collision in the credit markets with the result being interest rates being bid up, the credit-sensitive sectors of the economy ultimately weakening and the economy losing its forward momentum.

BUDGET DISAPPOINTMENTS YEAR AFTER YEAR

The Reagan administration has submitted deficits in the vicinity of $180 billion for fiscal years 1984–87, falling to $123 billion by fiscal 1989 A review of federal budget estimates in the past is instructive, as shown in table 1. The pattern is clear. Usually budgets have ultimately come in far less favorably than anticipated, as the fiscal 1978 and fiscal 1982 record shows, and as is sure to be the case when fiscal 1985 finally becomes history. There are three major reasons why budget outcomes differ from budget proposals, and usually in the negative direction.

TABLE 1

[In billions of dollars]

Date and source	Surplus (deficit)
Fiscal year 1978:	
January 1975 Ford	−19.6
January 1976 Ford	−22.8
January 1977 Ford	−47.0
January 1978 Carter	−61.8
Actual	−48.8
Fiscal year 1982:	
January 1977 Ford	28.6
January 1978 Carter	45.2
January 1979 Carter	37.8
January 1980 Carter	4.8
January 1981 Carter	−27.5
March 1981 Reagan	−45.0
January 1982 Reagan	−98.6
Actual	−110.6
Fiscal year 1985:	
January 1980 Carter	158.6
January 1981 Carter	84.7
March 1981 Reagan	5.8
January 1982 Reagan	−71.9
January 1983 Reagan	−194.0
January 1984 Reagan	−183.7

First, tax receipts are not as large as expected, either because anticipated tax increases do not occur or because other tax reductions are enacted which are not anticipated in the initial budget submission.

Second, programmed spending cuts do not occur and other spending increases that were not anticipated in the budget are enacted.

Third, the economic assumptions which underlie the budget prove to be too optimistic, yielding reduced revenues and higher outlays. If this past pattern holds true, the widely anticipated serious deficit situation in the coming years may become truly critical.

PRESIDENTIAL ECONOMIC ASSUMPTIONS

Table 2 shows real GNP growth rates assumed under Presidents Ford, Carter and Reagan over the last ten years, along with the actual outcomes. The patterns is clear. In the short term, presidential economic assumptions for real GNP growth are reasonably accurate. In the outyears, however, real GNP growth is routinely far short of what is assumed in the budget. This problem is neither a new nor a partisan one. Indeed, in the president's budget document for years a paragraph has been included which clearly labels the outyear economic assumptions as precisely that—assumptions, not economic forecasts of economic activity. These figures are a blend of hopes and aspirations of the proposing administration. Nevertheless, users of the budget document often neglect this important proviso, and this neglect leads to the recurrent problems of economic outcomes less favorable than anticipated, and consequently budget outcomes also less favorable.

TABLE 2.—ECONOMIC ASSUMPTIONS, REAL GNP

[Percent change]

Date and source	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
2/75 Ford	−3.3	4.8	5.6	6.5	6.5	6.5									
1/76 Ford	−2.0	6.2	5.7	3.9	6.5	6.5	4.9								
1/77 Ford		6.2	5.2	5.1	5.9	5.5	3.9	3.5							
1/78 Carter			4.9	4.7	4.8	4.8	5.0	4.7	4.2						
1/79 Carter				3.9	3.3	2.5	4.2	4.7	4.4	3.4					
1/80 Carter					2.3	−0.6	1.7	4.3	5.0	4.9	4.7				
1/81 Carter						−0.1	0.9	3.5	3.5	3.7	3.7	3.7			
2/82 Reagan							2.0	0.2	5.2	5.0	4.7	4.4	4.3		
1/83 Reagan								−1.8	1.4	3.9	4.0	4.0	4.0	4.0	
2/84 Reagan									3.3	5.3	4.1	4.0	4.0	4.0	3.9
Actual	−1.2	5.4	5.5	5.0	2.8	−0.3	2.6	−1.9	3.3						

Source: Federal Budgets, various years.

In more detail, the Reagan administration's economic assumption for years 1984-89 are shown in table 3. The Wharton forecast is that the economy will not perform quite so favorably. While there is precedent for five years of real GNP growth in the vicinity of 4 percent—the precedent is 1962-66—a repeat performance seems unlikely. In 1962, the inflation rate was 1.8 percent and Treasury bills were yielding 2.8 percent. During the five subsequent years of strong economic growth, the inflation rate and interest rates nearly doubled. This is to be expected as the economy becomes more fully utilized and employed.

TABLE 3.—ACTUAL AND REAGAN ECONOMIC ASSUMPTIONS, FEBRUARY 1984

	Real GNP	GNP price deflator	Nominal GNP	Unemployment rate	13-week Treasury bills
1960	2.2	1.6	3.8	5.5	2.9
1961	2.6	0.9	3.6	6.7	2.4
1962	5.8	1.8	7.7	5.6	2.8
1963	4.0	1.5	5.6	5.6	3.2
1964	5.3	1.5	6.9	5.2	3.5
1965	6.0	2.2	8.4	4.5	3.9
1966	6.0	3.2	9.4	3.8	4.9
1967	2.7	3.0	5.8	3.8	4.3
1968	4.6	4.4	9.2	3.6	5.3
1969	2.8	5.2	8.1	3.5	6.7
1970	−0.2	5.4	5.2	5.0	6.4
1971	3.4	5.0	8.5	5.9	4.3
1972	5.7	4.1	10.0	5.6	4.1
1973	5.8	5.8	11.8	4.9	7.0
1974	−0.6	8.9	8.1	5.7	7.8
1975	−1.2	9.2	8.0	8.5	5.8
1976	5.4	5.2	10.9	7.7	5.0
1977	5.5	5.8	11.7	7.0	5.3
1978	5.0	7.4	12.8	6.1	7.2
1979	2.8	8.7	11.7	5.8	10.1
1980	−0.3	9.2	8.8	7.2	11.4
1981	2.6	9.4	12.2	7.6	14.0
1982	−1.9	6.0	4.0	9.7	10.6
1983	3.3	4.2	7.7	9.6	8.6
1984e	5.3	4.5	10.1	7.8	8.5
1985e	4.1	4.8	9.1	7.6	7.7
1986e	4.0	4.5	8.7	7.3	7.1
1987e	4.0	4.2	8.4	6.8	6.2
1988e	4.0	3.9	8.1	6.1	5.5
1989e	3.9	3.6	7.6	5.7	5.0

However, the 1984-89 assumptions coupled rapid year-after-year real GNP growth with declining—not rising—inflation and interest rates. Since net interest has become a very sizable component of federal spending, because of large deficits year after year, the interest rate assumptions which underlie the budget are critical.

THE WHARTON BASELINE OUTLOOK

The Wharton baseline outlook, completed on February 22, 1984, shows an economy growing rapidly in 1984, but sliding to a 3.1 percent growth rate in 1985, and to a 0.6 percent rate of growth in 1986. Selected economic indicators from this forecast are shown in table 4. The inflation rate, low now, will gradually rise as the economy becomes more fully employed. Rising private-sector demands for credit accompanied by still-high public-sector demands for credit will lift interest rates, thereby effectively reducing activity in the housing sector, slowing the growth of business spending on plant and equipment to near zero and turning productivity negative once again.

TABLE 4.—SELECTED ECONOMIC INDICATORS WHARTON BASELINE 0284

	1983	1984	1985	1986
Real GNP (percent)	3.3	5.8	3.1	0.6
Unemployment (percent)	9.6	7.6	7.3	7.5
Current account (billion)	−$38.0	−$57.8	−$51.3	−$27.2
GNP deflator (percent)	4.2	4.5	5.8	6.2
Productivity change (percent)	3.1	2.4	0.9	−0.3
Change in M1 (percent)	10.0	6.0	3.8	5.7
Treasury bill rate (percent)	8.6	9.3	11.1	11.3
AAA bond rate (percent)	12.0	12.2	12.8	12.7
Consumer expenditure (percent)	4.2	4.3	2.2	1.2
Business fixed investment (percent)	1.5	13.9	5.4	0.8
Unified deficit (billion) [1]	$195.4	$169.7	$181.9	$212.8
Housing starts (millions)	1.72	1.86	1.57	1.49

[1] Fiscal year.

This scenario assumes that no major tax or spending actions will be enacted in calendar 1984. However, Wharton assumes that effective on January 1, 1986, and enacted in 1985 will be an increase in indvidual income taxes on $20 billion and an increase of $10 billion in corporate taxes. On the spending side of the budget, Wharton assumes that defense outlays will be reduced to an approximately 9 percent nominal rate of growth in 1986 and that transfer payments will be slowed by a like amount. Wharton further assumes that money growth will slow in 1985, in response to the continued high deficits and rising inflation rate, contributing to the 1986 weakness. The joint impact of the weaker economy and these fiscal actions will lead to a deficit in fiscal 1986 of approximately $213 billion.

POLICY ACCORD ALTERNATIVE

The strongest growth in the current cyclical upswing is now behind us. The natural movement of the economy will be toward slower growth, higher inflation and higher interest rates. There is, indeed, some risk that fiscal actions to slow the deficit which would inherently be contractionary in nature would be implemented at just the time in which they would be pro-cyclical; that is, they might slow the growth rate even more, converting a growth pause into a full-fledged recession.

The Wharton model has been simulated for an exercise that changes the mix between fiscal and monetary policy—and does so in 1984, while the economy still has a substantial amount of upward momentum and before the natural risks of a cyclical downturn become extremely large. The results of this exercise are shown in table 5. The guiding assumption is that the budget outlook is so widely regarded as unsatisfactory that remedial action is taken during 1984, even though it is an election year. Late in 1984, individual taxes are raised by $15 billion at an annual rate, and corporate taxes by $5 billion. These tax increases are further enlarged in 1986. Similarly, defense spending was reduced by $10 billion and transfer payments were reduced by an equivalent amount. For 1986, these reductions were doubled. In return, it was assumed that Federal Reserve monetary policy is easier. Both short-term amd long-term interest rates fall sharply, partly in response to the weaker economy and looser monetary policy, and partly in response to improved expectations in the financial community. The dollar on exchange markets was assumed to fall by 5 percent in the 1984 fourth quarter, and 10 percent thereafter relative to the baseline.

TABLE 5.—SELECTED ECONOMIC INDICATORS POLICY ACCORD ALTERNATIVE

	1983	1984	1985	1986
Real GNP (percent)	3.3	5.3	4.0	3.8
Unemployment (percent)	9.6	7.8	7.2	6.2
Current account (billion)	−$39.7	−$64.8	−$66.7	−$29.1
GNP deflator (percent)	4.2	4.6	5.2	6.8
Productivity change (percent)	3.1	2.7	1.8	2.1
Change in M1 (percent)	9.6	5.7	5.6	6.1
Treasury bill rate (percent)	8.6	8.6	8.0	9.5
AAA bond rate (percent)	12.0	11.7	9.6	10.0

TABLE 5.—SELECTED ECONOMIC INDICATORS POLICY ACCORD ALTERNATIVE—Continued

	1983	1984	1985	1986
Consumer expenditure (percent)	4.2	4.4	1.8	3.0
Business fixed investment (percent)	1.1	12.5	8.2	7.9
Unified deficit (billion) [1]	$195.3	$177.4	$152.7	$86.4
Housing starts (millions)	1.72	1.73	2.15	1.97

[1] Fiscal year.

Initially, the economy is weakened in the normal way by these contractionary fiscal measures. However, the decline in interest rates quickly lifts the credit-sensitive sectors of the economy and by later in 1985, real growth is on a higher path. Housing activity moves up, business fixed investment spending risks rises and productivity is lifted as well. During the first two years, the inflation is subject to cross currents. At the outset, the weaker economy slows the inflation rate while the decline in the dollar raises inflation. By 1986, however, the economy has moved substantially closer to full employment and the inflation rate is beginning to exhibit some demand-pull characteristics. By fiscal 1986, the deficit in this scenario falls to $86.4 billion, a substantial improvement from the $212.8 billion Wharton baseline deficit.

SUSTAINING BIG DEFICITS INDEFINITELY

There is no reason why $200 billion deficits in the coming years inherently would cause the economy to quickly collapse. Deficits of this order of magnitude would absorb a very large share of the economy's total capacity to save. The public sector would, in effect, crowd out must of the private sector from the credit markets. Both residential and nonresidential investment spending would be weak because of high interest rates, as would the U.S. export position. As a consequence, the two areas of strength in the economy would be in government spending and the noninterest rate-sensitive components of consumption. Over time, of course, as the nation's capital stock continued to age, the inflation rate would gradually be lifted, but this process would build only slowly over many years.

SUMMARY

The present and emerging budget situation is serious and seems likely to worsen. The near $200 billion deficit of 1983 was not, and the anticipated near $200 billion deficit of 1984 will not be a major problem. Indeed, this fiscal stimulus is largely responsible for the solid recovery. However, similar-sized deficits in 1985 and 1986 are troublesome and the tradeoff on deficit-reducing actions would appear to be as follows. Growth still above trend during 1984 suggests that the earlier that fiscal restraint is applied, the less would be the risk that the economy would fall into recession and the more shallow the economic slowdown would be. Conversely, the later that fiscal restraint is applied, when the credit-sensitive sectors of the economy have weakened further and interest rates have risen more, when inflation is higher and the economy has slowed more of its own momentum, the greater would be the risk that another major recession would result.

Mr. MITCHELL. Thank you very much.

I think it is best to proceed, unless I have some disagreement from my colleagues, to get the testimony from all four of the panelists and then put questions to you.

Hearing no disagreement, Dr. Black, please proceed.

TESTIMONY OF HAROLD A. BLACK, PROFESSOR OF FINANCE, HOWARD UNIVERSITY

Mr. BLACK. Thank you, sir.

I am rather uncomfortable sitting here between two forecasters, given what my opening statement is going to be; that is, recent history has shown that the projections of economic forecasters have been less than accurate with regard to the impact of high deficits on the economy.

Mr. Mitchell. There is a side entrance, if you want to use that to exit. [Laughter.]

Mr. Black. In 1981, the deficits were widely predicted to impact on the economy by causing the level of inflation to remain high. Inflation fell. In 1982, deficits were going to cause higher interest rates. Rates fell. In 1983, the prediction was that deficits were going to prevent recovery. Economic recovery is occurring. Consequently, every widely-held prediction as to the impact of the deficit has not been sustained. There must be a reason. The obvious one is that we simply do not know much about the impact of the deficit on the economy.

The recent prediction that is in vogue pertains to the impact of the deficit on economic growth. Herbert Stein, for example, believes that the budget deficit of 1 percent of GNP reduces the growth rate of the economy by three-tenths of 1 percent. That means that if the average deficit projected by the CBO through 1989 of 5 percent of GNP obtains, then growth will be 7.5 percent less.

The rationale for such claims as to the impact of the deficit on growth rests in large part with the notion of "crowding out." The percentage of net credit extensions to the nonfinancial sector during the first 6 months of each year has shown a dramatic shift from the corporate sector to the Government sector.

The net credit extensions to the corporate sector was 24.4 percent during the first 6 months of 1981, 25 percent for 1982, and only 7.6 percent for 1983. On the other hand, extensions to the U.S. Government were 22.4 percent in 1981, 30 percent in 1982, and 45.6 percent in 1983.

Thus, the Federal Government is absorbing an ever increasing share of the Nation's net savings. The effect of this will be in the opinion of Prof. Benjamin Friedman, a major impediment to any increase in the U.S. economy's net investment rate. Indeed, that rate may be depressed during the eighties.

The crowding out of private domestic investment by the U.S. Government occurs due to the lack of profit motive on the part of the Government. When the Government has to enter credit markets, there is an increase in the demand for loanable funds over and above the demand from private investors. The new demand results in a higher rate of interest. Some investors find that investments that were profitable prior to the entry of the Government into the market are no longer profitable. Thus, private investment falls. The Government, of course, need not concern itself with the consequences of its actions on its profitability.

The resulting interest rates are higher than what would occur in the absence of the Government. Indeed, currently interest rates have remained high in real terms, that is, adjusted for inflation. Contributing to those high rates has been the role of expectations.

Expectations play a significant role here due to perceptions about the impact of the deficit on the economy, be those perceptions correct or incorrect. Given that the current perception is that the high deficits are going to lead the economy into a period of slow growth, or even recession, and some soothsayers predicting a rekindling of inflation, rates have remained high. Investors, fearing a slowdown in growth and a possible recession, demand higher nominal rates because of the increase in perceived risk of default. Likewise, if a fear of inflation is also widespread, investors will demand higher nominal rates to protect the real value of their investments.

Consequently, the way out of this is to change expectations. This is the difficult part. Are expectations based on the predicted consequences of the high and continuing deficits? To an extent, this must be the case. However, those expectations alone are not sufficient to sustain high interest rates into the future.

For example, although a fall in economic growth is predicted due to a decline in investment created by high interest rates, such has not yet occurred. Thus far, business fixed capital formation in the words of Rudolph Penner, "does not seem to be adversely affected by the high levels of interest rates." Penner speculates that the negative impact of high interest rates on investment may be offset by the favorable impact of the tax cuts of 1981 and 1982. Often we forget that interest rates are not the sole cause of investment behavior.

One reason the economic forecasts have not been accurate has been attributed to the gyrations in the money supply. The growth of the monetary base fell from 8.3 percent in 1980 to 4.3 percent in 1981. The Fed then changed directions, allowing the base to grow at 7.9 percent in 1982 and 9.4 percent through the 12 months ending last June. Since last July, the Fed has retrenched and the base has been growing by 5.3 percent.

These actions by the Fed confounded the economic forecasts and altered short-run expectations. If inflation is rekindled, it will be because the Fed allows rapid and persistent money growth. Inflation is a creation of the Federal Reserve. The only effective anti-inflationary policy is one where the Fed does not allow rapid money growth. This will also reduce inflationary expectations.

If those expectations currently exist, it is because we have become wary of the Federal Reserve, which is rational given the erratic behavior of the money supply. A friend of mine describes their actions as akin to an individual driving a car with both feet on the floor, one on the accelerator and the other on the brake. The car lurches forward at various speeds, depending on the amount of pressure being applied by which foot.

Consistent money growth must be coupled with consistent and complementary fiscal policy. Over the past years, there has been a serious imbalance in macroeconomic policy. That has resulted in high inflation and high unemployment. Faced with the high deficits, there has been some agitation for increases in taxes. However, raising taxes is precisely the incorrect measure for the ills of high unemployment in basic industries and anemic capital formation.

Raising taxes will exacerbate the problem. Deficits can be reduced not only by raising taxes, but also by a reduction in spending. If there is no change in spending, then there will be no reason why interest rates should fall. This is because a major contributor to the high level of interest rates is Government demand. If that does not change, then interest rates will remain high. If in that scenario taxes are raised, then whatever drop in interest occurs would occur because of investment demand falling as income drops. However, even that is not certain, for Government spending may increase due to the recession that would be prompted by that increase in taxes.

Consequently, I believe the following:

One, interest rates reached historically high levels in the 1981-82 period because of the persistent inflation of the 1970's. Corporations resorted to bank loans and money markets to finance expansion, driving up rates. Households invested in tangible assets rather than paper assets. The rate of aggregate savings declined. Individuals eschewed traditional forms of savings and invested in variable rate instruments. The financial system accommodated the inflation by becoming a passthrough vehicle. Financial institutions adopted variable rate savings instruments and placed greater reliance on short-term CD's. All of these factors led to high interest rates.

Two, interest rates have continued high for several reasons. First, however, do not forget that relative to past experience, rates have fallen. They have not fallen as far as they should because of inflationary expectations coupled with perceptions as to risk. These are reinforced by the growing presence of the Government in credit markets. As before, remember that that presence is due to spending demands.

I am not convinced that the deficit, per se, is a contributing factor. Rather, it is the spending component of the deficit that is the key ingredient. Therefore, I disagree with those who assert that the deficit will have or has had an impact on the level of interest rates.

Also, remember that one of the major misconceptions that abounds is the relationship between money supply changes and interest rates. The oft-heard inverse relationship exists only in the short run. The long-run impact is a positive one. Thus, all those calling for expansion in the money supply will find inflation rekindled and even higher interest rates.

Three, given current economic policy, I see no reason for optimism. As I am certain you are aware, that although defense spending is 6.7 percent of GNP, it was around 8 percent in the early 1970's, and yet the deficit is now larger. The tax cuts left revenues at 19 percent, which was simply a rollback to previous levels. Spending, however, has grown from 20 percent of GNP in 1980 to 25 percent of GNP today. The reason, of course, has been our generosity in entitlements and other transfers. These have often been referred to as being uncontrollable, but they are uncontrollable because we deem them to be so. All of us are nonetheless aware that one day someone, if not us, will be forced to control the uncontrollable.

Four, the impact of all this on small business has been interest rates above that of other sectors. This is because of risk, both real and perceived. If small businesses are riskier than other enterprises, then the interest rate charged to them must be higher to compensate for this risk. If, in addition, a slowdown in economic activity is expected, the problem is compounded. Given that small businesses are more vulnerable to economic fluctuations, investors will demand even higher interest rates. The way to combat this is to alter expectations.

Five, there are solutions, but no easy ones.

Thank you for allowing me the opportunity to share my views with you.

Mr. MITCHELL. Thank you for some very interesting and provocative testimony.

Mr. Bergsten.

TESTIMONY OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BERGSTEN. Thank you, Mr. Chairman. It is a pleasure to see you again and a pleasure to come here before the committee to talk about the international dimension of the problem that you raise. I think it is particularly appropriate to do so, since even at this point in time there is not wide enough recognition of how important that international dimension is. It is, I will argue, central to the outlook for the economy as a whole, and small business in particular.

I think most of you probably know some of the structural data. One out of every six jobs in the manufacturing sector now depends on exports; over 20 percent of all manufactured output is exported; about one-third of corporate profits in this country derive from the international activities of our firms, both in their foreign investments and their export sales. So, at the structural level, the international side is very important.

What you may not realize is that what has happened at the margin over the last 5 to 6 years in our economy as a whole has been determined by what has happened to our foreign sector. From 1978 to 1980, when we had modest but positive growth in the economy, three-quarters of that total growth came from the improvement in our trade balance. If you will recall, at that time, the generalization has been made that most of the increase in jobs came from small business expansion; if you put the two together, and it's quite clear that small business was playing a big part in the expansion of our trade sector and getting enormous improvement, an improvement that was central to the overall economic growth of the country.

In the 1981 and 1982 recession however, the decline in our real trade balance equalled three-quarters of the total decline in real GNP. Indeed, it was twice as great as the decline in the housing sector and was by far the biggest single component of the recession. That's a stunning fact, but it is true. Just look it up in the GNP numbers.

So, over the last 5 to 6 years, what has happened in our international position has been of critical, even decisive, importance to our economy's growth or recession as a whole. Therefore, I think it is most appropriate that you look at this topic in the course of this morning's hearing.

Now, what is the situation now in terms of the impact of the budget, interest rates and all that, via the international sector? I would suggest that it is terribly important and terribly worrisome. Yesterday's record trade deficit numbers that were just announced for January highlight the problem. But it's a much deeper one.

I would submit that the huge budget deficits are, in fact, a major element in causing very high interest rates in this country. Those high interest rates, in turn, are a very major element in having pushed the exchange rate of the dollar to the level against other currencies which it has reached over the last 3 years. That exchange rate level for the dollar, according to a very thorough analysis that we did at my institute and published last fall, is something like 25 percent in excess of the exchange rate relationships that would be justified by underlying competitive relationships between the United States on the one hand, and Japan, Germany, and other foreign competitors on the other.

When I and others use the term "dollar overvaluation," that's what we mean—that the dollar is simply priced much higher than would be justified by the underlying economic and competitive relationship between the United States and other countries in the world.

Now, when you have dollar overvaluation so defined, on the order of 25 percent, what you are, in essence, doing is putting a tax of 25 percent on everything you try to sell abroad and you are paying a subsidy of 25 percent on every product coming into this country from abroad to compete with domestic production. What you are doing, in essence, is undermining the competitive position of American firms and workers on the order of 25 percent against their competitors from around the world, whether they're competing within our own market or in third markets worldwide. That has an enormous impact on our economy, jobs, investment levels, and the like.

The rule-of-thumb is that for every percentage point deterioration in our international competitive position, our trade balance loses about $3 billion. So if we are over-valued by 25 percent—and I would submit that that's probably a conservative judgment—we would expect our trade balance to deteriorate by something like $75 billion. Lo and behold, that's exactly what has happened. The numbers that came in yesterday for the month of January indicate that the trade deficit has already reached an annual rate in excess of $100 billion. That's up from a then-normal level of about $25 billion that we had in 1980 and 1981.

My own projection is that this year the trade deficit will hit about $120 billion for the year as a whole, and contrary to what Secretary Baldrige was recently quoted as saying, it's going to get worse in 1985. My own projection is that the trade deficit will hit about $150 billion in 1985, and it is going to continue to deteriorate until and unless the dollar exchange rate begins to turn around substantially.

Now, what does that mean for the economy? There is another rule-of-thumb. Every billion dollars of trade balance is worth about 25,000 jobs. So when we lost $100 billion of trade balance, that's a loss of jobs or job opportunities on the order of 2.5 million. And so we have lost net something like 2 to 2.5 million jobs, about three-quarters of that in manufacturing, as a result of the international deterioration of our competitive position, which gets back to high interest rates, budget deficits, and the like. So the immediate effect, in terms of drag on GNP and job loss is substantial.

Beyond that comes a longer range consideration which I think is now beginning to creep into the picture. As American business begins to fear that the budget deficits are going to be with us for some time, and therefore high interest rates are with us for some time, and therefore dollar overvaluation may be with us for some time, many of them are beginning to ask the question, "Should I invest in the United States?" Because with an enormous price disadvantage, on the order of 25 percent or so, if that were to be perpetuated—as Marty Feldstein would say, "as long as the budget deficits are going to last"—then the question comes in the long run investment planning of our firms: "Should we put a plant in the United States, or should we invest abroad?"

Recall that the last time we had substantial dollar overvaluation, in the late sixties and early seventies, which had to be corrected by the two devaluations in 1971 and 1973, that was also the period of massive foreign direct investment by American firms. There were lots of other factors involved, and I don't mean to suggest that it was only the exchange rate, but there was a very direct correlation between growing overvaluation of the dollar in the late sixties and early seventies and massive foreign direct investment by American firms. In my judgment, that is the threat of deindustrialization if, indeed, there is any such threat, in our economy at this point in time.

There is one final piece of the picture that has to be included. At some point—and who knows when it will be—this massive trade deficit will lead to a collapse of confidence in the dollar. Just as we say in 1977 and 1978, as we have seen in other periods of history, the dollar will come down very, very sharply in the exchange markets. In a fundamental sense, that is needed, of course, to correct the overvaluation. But if it comes via a massive, precipitous outflow of that capital that has flowed in over the last several years, it, too, will have very adverse effects. A rapid fall of the dollar pushes up inflation, pushes up interest rates because the foreign capital is flowing out instead of flowing in, and maybe even triggers a defensive response by the Federal Reserve to push interest rates up to keep the dollar from falling so rapidly, and therefore also has adverse effects on the economy. At this point it is very hard, in fact, to see a controlled, gradual, constructive correction of the dollar imbalance through a soft landing. That point, I'm afraid, may have already been passed.

So what we are in for is a combination of continued high and growing trade deficits, at least for awhile, and when the dollar collapse comes, some adverse effects from that, and therefore, perhaps the worst of both worlds in terms of our international economic position for the next couple of years.

The conclusion is simple and straightforward. The international dimension of the economic situation and outlook adds very substantially to the case for doing something quickly and massively about the budget deficit in order to help bring interest rates off, in order to get our international position back in at least reasonable shape before it is really too late.

Thank you, Mr. Chairman.

[Mr. Bergsten's prepared statement follows:]

PREPARED STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS [1]

INTRODUCTION

The outlook for small business in America must include a careful look at the international position of our economy. This can been seen most clearly by noting that changes in the external position of the United States have dominated the overall course of our economy during five of the last six years. From 1978 to 1980, three-quarters of the total growth in real U.S. gross national product was accounted for by the sharp improvement in our net export position.[2] From the first quarter of 1981 through the fourth quarter of 1982, the decline in net exports equalled three-quarters of the total decline in real GNP—and was by far the largest single factor in the recession. Hence it is extremely perilous to ignore the international impact of US "domestic" policies, as has been done for the past three years, including its impact on small business.

To be sure, a number of steps have been taken in recent years to enhance the ability of small business in this country to take advantage of opportunities in foreign markets. The Export-Import Bank has instituted a special program for smaller firms. Export trading companies have been authorized by Congress, largely to permit smaller firms to combine for export purposes. A number of efforts have been undertaken to relax the disincentives to exports, such as foreign policy controls, which often hit small businesses particularly hard.

Unfortunately, however, all these efforts are being swamped by a massive new disincentive to American exporting and import-competing firms, including smaller firms. These international problems arise, of course, because the prospect of huge and unending budget deficits produces extremely high US interest rates. In turn, these high interest rates attract massive inflows of capital and produce severe overvaluation of the dollar in the exchange markets, compared with the underlying competitive relationship between the United States and other major countries.

A study published by the Institute for International Economics in September demonstrates that the dollar is overvalued by 20/25 percent.[3] This has the same economic effect as placing a tax of 20-25 percent on all US exports and paying a subsidy of 20-25 percent on all imports into this country. The combination of high interest rates and dollar overvaluation, both of which derive in large part from the current and prospective budget deficits, produces major international consequences which have extremely negative effects on the United States itself.

THE TRADE DEFICIT

As I predicted over two years ago,[4] the U.S. trade deficit will soar to at least $100 billion in 1984. Indeed, that rate has been approached during the last few months, and I now fear that the trade deficit may hit $120 billion this year. This in turn implies a current account deficit of $80 to $100 billion, five to six times as great as the pre-1983 record.

Such further deterioration in our external position would take 1 to 1½ percentage points off the recovery this year, after taking off about a full percentage point in 1983. By late 1984, over two million jobs will have been lost as a result of the deterioration in the trade balance. Most of these losses come in the manufacturing sector, encompassing both key basic industries which compete against imports (such as steel and autos) or rely heavily on export markets (such as farm machinery and high-tech industries which do both. Many of them come in small businesses, either because of direct losses of market position or indirectly as a result of lost positions by larger firms to which they are suppliers.

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[1] Assistant Secretary of the Treasury for International Affairs, 1977-January 1981; Assistant for International Economic Affairs to the National Security Council, 1969-May 1971

[2] During that period, U.S. exports grew twice as fast as world trade. By early 1981, the United States had regained a share of world markets for manufactured goods which it had last experienced in the late 1960s. The current account improved by $15 billion despite a further rise of $40 billion in oil import costs due to the second oil shock—implying a gain of $55 billion on everything else in just two years. Assertions that the United States faces some fundamental problem in competing in the world economy as thus totally disproven by the facts.

[3] John Williamson, "The Exchange Rate System," Washington: Institute for International Economics, September 1983.

[4] In "The Costs of Reaganomics," Foreign Policy, fall 1981, pp. 28-29. See also, "The International Implications of Reaganomics," Kieler Vorträge, no. 96, February 18, 1982. Both are reprinted in "The United States in the World Economy: Selected Papers of C. Fred Bergsten 1981-1982," Lexington, Mass.: D.C. Heath and Co., 1983.

The overwhelming cause of the trade decline, to date, is the overvaluation of the dollar. Traditionally, every percentage point loss of international price competitiveness costs our merchandise trade balance about $3 billion. Thus the overvaluation of 20-25 percent, first reached in mid-1981, would be expected to generate annual losses of $60-75 billion—which, from the starting point of a $25 to $30 billion deficit in 1979-81 (more than offset in those years by a surplus on international services transactions—takes the deficit to about $100 billion.[5]

In addition, the United States seems likely to continue growing faster than all other major countries in 1984 (for an unprecedented second straight year). DRI projects the United States at 5.3 percent and the rest of the world at about 3.5 percent, while Project LINK has the United States at 5.9 percent and the rest of the OECD at only 3.8 percent. This means that US demand for imports will be growing much faster than foreign demand for US exports.

Furthermore, the US income elasticity of demand for imports is substantially higher than that abroad. U.S. imports now tend to grow about 50 percent faster, compared with our GNP growth, as do imports abroad. So the continuing "growth gap" will add at least $20 billion more to our trade balance deterioration.

Three other factors could affect the outlook. There should be a modest pickup in the imports of some debt-ridden developing countries, such as Mexico, which will help US exports. Our terms of trade could continue to improve, as happened—due mainly to the strong dollar itself—throughout 1981-83 (masking much of the deterioration in our real trade balance). But the long-anticipated fall in the dollar, if it materializes in 1984, could have the opposite effect instead; even a 10 percent fall in the dollar could, in the first instance, add as much as $10 to $15 billion to the trade deficit.[6]

The most likely trade outcome for 1984 is thus a merchandise deficit of about $120 billion—a bit larger than the $110 billion forecast in the recent Annual Report of the Council of Economic Advisers.

Unfortunately, the trade deterioration is virtually certain to continue at least into 1985. The same factors as in 1984 suggest this income. The trade impact of the latest surge in the dollar will continue into 1985, in view of the time lags involved. Moreover, the "growth gap" is likely to continue—DRI and Project LINK see U.S. growth at about 3½ percent, compared with 3 percent or less for the rest of the world. By then, a lower dollar is very likely—with adverse J-curve effects for a while.

Quantitative forecasts are obviously less certain as the forecast period recedes into the future, but the merchandise deficit could easily approach $150 billion in 1985. If the services surplus continues to decline, as seems inevitable, the current account deficit would then be at least $125 billion. Enough additional job loss would occur to take the cumulative total, from 1981, to beyond three million.

The situation beyond 1985 will depend on the further course of the two variables emphasized: (1) if, when and by how much the currency misalignment is corrected, and (2) if, when and by how much the "growth gap" between the United States and other major countries is narrowed or reversed. Recall, as noted above, that our real net exports deteriorated sharply throughout the recession of 1981-82—in fact, equalling about 75 percent of the total fall in real GNP. Hence the inevitable slowdown in U.S. expansion need not, by itself and without the needed exchange-rate realignment, improve the trade balance to any significant extent. DRI has forecast a continuing deterioration of the U.S. current account, albeit at lower levels than my own forecasts, with the merchandise imbalance approaching $200 billion later in the decade. The associated job losses would exceed four million.[7]

DEINDUSTRIALIZATION

Beyond the trade deficits per se, dollar overvaluation poses a growing threat to future investment in US plant and equipment. A large segment of American industry, running as high as 60-75 percent of some estimates, must now compete actively with firms based abroad either in world markets or here at home. Yet many of these firms are increasingly aware that the huge (20-25 percent) price disadvantage caused by dollar overvaluation may persist well into the future, if no action is taken to deal with the underlying cause of the problem—the budget deficit.

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[5] This is a highly conservative estimate, because the appreciation of the dollar—from its low point in 1978 to its recent and current highs—averaged about 40 percent, implying a possible trade loss as high as $120 billion from the currency change alone. This would take the merchandise deficit to about $150 billion.

[6] As a result of familiar J-curve effects, assuming a 50-percent price passthrough.

[7] One implication of all this is that, by 1985 or 1986, the United States will again become a net debtor country—reversing in four years the entire net buildup of foreign assets of the past seven decades and returning to our status of the nineteenth century. Indeed, on my estimates, the United States by 1986 will be a net debtor on roughly the same order of magnitude as Brazil and Mexico today: close to $100 billion.

Some firms are therefore beginning to question the wisdom of future investment in the United States. Continued sizable dollar overvaluation is likely to force them to invest abroad instead, not from any "runaway plant" mentality but simply for self preservation, particularly because their foreign competitors are enjoying such huge profits and may be reaping irreversible competitive gains. Indeed, massive foreign direct investment was one result of the last prolonged period of dollar overvaluation in the late 1960's and early 1970's.[8] Such a shift would of course further reduce job opportunities in the United States. In addition to jeopardizing the sustainability of the present recovery, this phenomenon is probably the greatest present cause of concern over any future "deindustrialization" of our economy.

For many small businesses, of course, the prospect is even more bleak. Many of them are simply too small to escape the adverse effects of an uncompetitive dollar by investing abroad, or sourcing their sales from existing foreign subsidiaries as large multinations are now doing to a considerable extent.

A "STABILIZATION CRISIS"

One other potential problem, recently outlined by my colleague Stephen Marris, is that the trade deficit itself will eventually produce such a precipitous fall in the exchange rate of the dollar as to have major adverse consequences for our economy.[9] Such a fall would come from a sharp reversal in capital flows, stemming from a collapse of international confidence in the sustainability of the American situation, which would then push US interest rates up both directly and—because the Federal Reserve would have to tighten money to stem the run of the dollar—indirectly.

ECONOMIC GROWTH ABROAD

The strong dollar, with its devastating effect on the US trade balance, is now enabling Japan and Europe to improve their competitive positions sharply and to experience rising trade surpluses. Hence the current US policy mix provides one positive impulse for the other industrial countries

Moreover, a sharp decline in the dollar would add significantly to inflationary pressures in the economy: a fall of 20 percent in the exchange rate would add about three percentage points to the CPI.[10] As a result, the United States would for a while get the worst of all worlds from its external accounts: a continued huge trade deficit, because of previous dollar overvaluation, and then higher interest rates and new inflationary pressures as well from a rapid fall of the currency. Again, urgent action is required—to begin the adjustment process soon enough to foster the needed currency correction in a relatively smooth manner, without a "free fall" a la 1978 and the enhanced risk of overshooting to an excessively weak (and inflationary) dollar once again.

On the other hand, and even leaving aside the moral implications of the richest nation in the world financing its budget deficits from other countries' savings, the high US interest rates (which cause most of the dollar strength) continue to depress economic activity abroad. This is partly because the international flow of investment resources. Even more importantly, most other major countries feel that they must maintain interest rates high enough to keep their exchange rates from weakening further, in light of the inflationary pressures—notably including higher prices for dollar-denominated oil and other commodities—which would result. Hence they are unable to use monetary policy to stimulate more rapid expansion of their economies; indeed, several of them are now maintaining interest rates far higher than called for by domestic conditions, and are thus retarding their own economies.

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[8] There were of course other major reasons for the expansion of foreign direct investment by US-based firms during that period. However, the buildup correlates almost precisely with the growing dollar overvaluation and, given the inherent lags in corporate planning, so did its slowdown from the mid-1970s (after the dollar devaluations of 1971-73). Likewise, investment in the United States by foreign-based firms was minuscule prior to those currency corrections but has expanded rapidly since then.

[9] Stephen Marris, "Crisis Ahead for the Dollar," Fortune, December 26, 1983.

[10] The correction in the exchange rate of the dollar which is needed, as noted above, would of course also produce such an effect—but in a more orderly way over a longer period of time. Indeed, the inevitable upward push in the CPI from dollar depreciation—which, it should be noted, does not affect the "core" or "underlying" inflation rate—is better taken now than later, given the continuing low level of recorded inflation, thus adding to the urgency of restoring dollar equilibrium.

At the same time, the most important of these countries—Japan, Germany, and the United Kingdom—are, in direct contrast to the United States, steadily reducing their budget deficits. Indeed, there is extensive political consensus in those countries for doing so, in the interest of long-run fiscal prudence. Hence neither monetary nor fiscal policy is available to promote their recoveries (though the immediate cyclical situation would seem to call for fiscal expansion instead). Partly as a result, the U.S. recovery has not yet spread; for example, US growth will exceed Japanese growth in both 1983 and 1984, a rare juxtaposition since the postwar reconstruction of Japan.

Thus the United States may wind up seeking to maintain its recovery in a largely stagnant world economy. The last time it tried to do so, in 1977-78, the result was a snuffing out of the US recovery—via a "stabilization crisis" of the type described above—rather than a generalization of US growth to the others. In light of the further integration of the United States into the world economy over the past five years, as described at the outset, it is doubtful that the United States can grow very fast for very long if the other major countries are not doing so, at least to some extent, as well.

So the impact of US policy on the rest of the world, which on balance is negative for most countries, will feed back adversely onto the prospects for sustainability of our own recovery. The situation would be worse if the United States is hit by a "stabilization crisis," as outlined above, because other countries would then probably face both a slackening of the American Economy and a decline over time in their competitive positions as the dollar fell.

CONCLUSIONS

The international effects of the present US policy mix are thus extremely costly for our own economy, including the small business sector, both directly via its impact on the U.S. competitive position and indirectly via its effects on the rest of the world. Substantial numbers of U.S. jobs and investments are being lost as a result.

It is imperative to attack the root of the problem: the prospect for huge and interminable budget deficits, which is the most important cause of both high interest rates and dollar overvaluation. In the absence of such an attack, any or all of the problems cited here could become acute and even unmanageable. Small business, perhaps even more than other sectors of our society, has a major interest in promoting such an outcome.

Mr. MITCHELL. Thank you very, very much. We have lots of questions for you.

Mr. Taub.

TESTIMONY OF LEON TAUB, CHIEF ECONOMIST, CHASE ECONOMETRICS

Mr. TAUB. Thank you, Mr. Chairman.

Does everyone have a copy of my testimony? I will refer heavily to the visual aids contained inside it.

Mr. MITCHELL. All the members of the committee have copies.

Mr. TAUB. Mr. Chairman, members of the committee, it is an honor to be here this morning to testify on high projected budget deficits and their potential impact on the economy and small business. The views I will present today do not necessarily represent those of the Chase Manhattan Bank, the parent corporation of Chase Econometrics. The main points of my testimony can be summarized as follows:

First, unless policy changes are made, the Federal budget deficit will continue at a $200 billion rate despite the recovery through 1985, and then begin rising.

Second, monetary policy during the past year has not been tight. During the next year, the conflict between fiscal policy and monetary policy will grow unless current fiscal policies are changed. The likely outcome of this conflict is a credit crisis some time between the summer of 1984 and early 1985.

Third, the economy has substantial amounts of unused capacity. Current fiscal policies will cause rapid real growth during the next 6 to 9 months. Unfortunately, inflationary pressures will also build somewhat.

Fourth, a timely deficit reduction could go a long way toward easing the conflict faced by the economy.

Fifth, higher interest rates have a particularly deleterious effect on small businesses.

If we could now turn directly to the exhibits.

The first graph is fairly straightforward. It shows the Federal budget outlook as presented by the administration and by the Congressional Budget Office. I would point out only that the Congressional Budget Office estimates are probably conservative, in that they do not assume any crisis in interest rates due to the conflict between the deficit and monetary policy. Indeed, they presume lower real interest rates in 1989 than today, despite over $300 billion budget deficits. That means that if we do have a conflict between fiscal policy and monetary policy, and interest rates rise, a snowballing effect will occur. We will have higher interest expenditures, lower real growth, higher deficits, et cetera.

The reason for this deficit can be seen in the second graph. This graph is a little bit unusual, in that it projects certain types of Federal expenditures relative to Federal revenues. As you can see, pensions, primarily social security and medicare, use up nearly 40 percent of Federal revenues. Defense takes another third of Federal revenues. Interest expense is another 15 percent. I have filled in the last percent through grants-in-aid. You will notice there is no all other sector. That means that if we decided not to change any of these budget items, but decided to balance the deficit only by cutting all other expenses, we would have to cut expenses for all other items to zero. That would include the budget of the Congress, the budget of the administration, NASA, numerous employment programs, et cetera.

The reason for this can be seen, in part, through the following two graphs. The first one shows social security expenditures as a percent of GNP. As you can see, it has been a strong growth item. In 1960, social security was only 2 percent of GNP; in 1970, it was approximately 3½ percent of GNP; today it is approximately 6½ percent of GNP, and by the end of the decade will be well over 7 percent of GNP. Since we are talking about percentages of our gross national product, this is a quite significant shift in national priorities.

Looking at the last graph on the deficit, you can see defense spending projections as a percent of various items. The bottomline shows what I take to be the administration argument, that as a percent of GNP, defense spending is not particularly high, certainly lower than it was during the Vietnam era, and rising relatively modestly. However, let's look at the top line which compares defense spending to available Federal revenues. By available Federal revenues, I have taken out trust fund revenues, primarily social security, but also the highway trust fund and a few other items. I have also taken out interest expenditures, assuming that they have first priority on general fund revenues. You can see is that if the administration's budget comes to pass, defense spending will encompass more than 80 percent of available Federal revenues.

Essentially, I believe that this graph explains the budget predicament which you find yourselves in. If the administration's defense spending projections are adhered to, virtually all of discretionary spending will be used up unless large budget defficts are allowed.

The President has asked the Congress to attempt to balance the budget without cutting defense spending, without cutting social security, and without a major increase in taxes. That is almost mathematically impossible, and it is certainly politically impossible.

Leaving the deficit for a moment, I would like to turn to monetary policy. If you look at the next graph, you can see that despite current high real interest rates, monetary policy has not been tight. In fact, the real monetary growth—that is, the growth in the money supply, less that used to accommodate inflation—has been more rapid than it has been in any single year in this past decade.

The reason we have high interest rates is not that monetary policy has been tight—the Fed has been trying to promote rapid growth—but simply that Federal deficits are large. Deficits are adding to credit demands at the current time, and as testimony earlier today has pointed out, it leaves investors with very little confidence that we will be controlling inflation in the future. Hence, it worsens economic expectations.

The next figure shows the economic outlook, or the key to the economic outlook, as we see it at Chase Econometrics—projected credit supply and projected credit demands, As you can see, a conflict is developing in 1984 and will continue to worsen, particularly the second half of 1984 and throughout 1985. The problem is that early in a recovery period it is typical for the economy to balance itself by the private sector financing large Federal deficits. The reason the private sector can do this is the rapid growth in corporate profits. What we have typically in the second half of recovery is declining Federal sector credit demands, which is accompanied by increasing private sector investment demands. We don't have that this time. As you can see, we project a fairly severe gap between available credit and the demand for credit in the second half of 1984 and in 1985.

That leads us to the economic outlook. First, we see no danger of the economy sliding into a recession. Contrary to a comment that was made earlier, in fact, we feel that as long as the Federal Government is running $200 billion deficits, you have the equivalent of a huge locomotive pushing the economy forward. However, with that locomotive pushing the economy forward, inflationary pressures will soon begin to build. We expect the inflation rate to be greater than 6 percent by the end of this year.

The credit conflict which I described earlier can occur at a variety of times. The data are not so precise that we can pick the month that a credit crisis will happen. However, I can tell you that if one doesn't happen in June, it will be more likely in July. If one doesn't happen in July, it will be more likely in August. If it doesn't happen in August, it will be more likely in September. Particularly during the fourth quarter of the year and into the first quarter of next year, the gap between available credit and the demand for credit will grow.

In order to see what would happen if we had a change in Federal policy, we ran some simulations of the Chase macroeconomic model. The next page shows four key indicators of what would happen. The baseline essentially was a worst case. It assumed the administration's defense projections, no change in taxes, and no change in spending this year. On top of that baseline simulation we assumed a significant deficit reduction program, perhaps $130 billion, and on top of that, that the Federal Reserve agreed to follow an easier monetary policy and let interest rates fall two percentage points. As you can see from the figures, the impact upon the economy was positive, not negative. Interest rates were substantially lower. The Federal Government deficit was substantially lower. The unemployment rate declined, and benefiting particularly greatly in 1985 was, of course, the net export position which Dr. Bergsten has just talked about.

One reason that it is important for this process to occur quickly was described by Dr. Bergsten. Essentially, he pointed out with respect to the international sector that we are mortgaging our future. I think the same thing is true with respect to the domestic sector as well.

If you look at the next slide that I have, you can see that even a relatively modest assumed deficit reduction, $120 billion over 3 years, results in a much larger impact on the deficit if we do it today and we have compensating easier monetary policy. Essentially, by agreeing on a program today, which will result in $50 billion savings by 1987, we can reduce the Federal budget deficit by almost $100 billion, almost twice the impact. The reason for that, of course, is that when one does run high deficits, one finds themselves in a situation where interest expenditures begin compounding.

The last point which I would like to make today is the impact of this type of crisis on small businesses. In the material prepared by the committee staff, you saw the impact of different interest rate conditions on interest rate levels by size of loan. Some of that information is reprinted on the graph to my left.

An interesting point is that in 1979, when there was no conflict between credit demands in the private sector and Federal Government and the economy's ability to supply credit, interest rates for small loans and interest rates for large loans were approximately the same. When we moved into the second half of 1981 and credit conditions became tighter, not only did all interest rates rise, but the differential between interest rates on small loans increased relative to the rate on large loans.

Then, after we had a period of economic crisis and the economy recovered, the interest rates on large loans fell immediately; but the interest rates on small loans stayed up. The reasons for this are clear. Not only do larger businesses start into crisis periods with greater assets, and greater ability to provide capital internally, but they also have alternatives in the capital market. Larger businesses have the alternative of borrowing in the commercial paper market as from banks. In addition, larger businesses can hedge against long-term increases in interest rates by selling bonds.

For example, perhaps the largest business of all, the Federal Treasury, has lengthened its debt obligations dramatically in the past year. Whereas last June Federal short-term debt, maturing in less than a year, was 60 percent of all debt obligations, it has now dropped to 52 percent of debt obligations. Large businesses can do the same thing by floating corporate bonds. Small businesses cannot protect themselves from an expected increase in interest rates.

Thank you.

[Mr. Taub's prepared statement with attachments follows:]

PREPARED STATEMENT OF LEON TAUB, CHIEF ECONOMIST, CHASE ECONOMETRICS

It is an honor to be here this morning to testify on high projected budget deficits and their potential effect on the economy and small businesses. The views I will present today do not necessarily represent those of The Chase Manhattan Bank, N.A., the parent corporation of Chase Econometrics. The main points of my testimony can be summarize as follows:

First, unless policy changes are made, the Federal budget deficit will continue at a $200 billion rate despite the recovery through 1985, and then begin rising. The structural deficit—the portion which must be cured through policy changes on either the expense side or the revenue side growing.

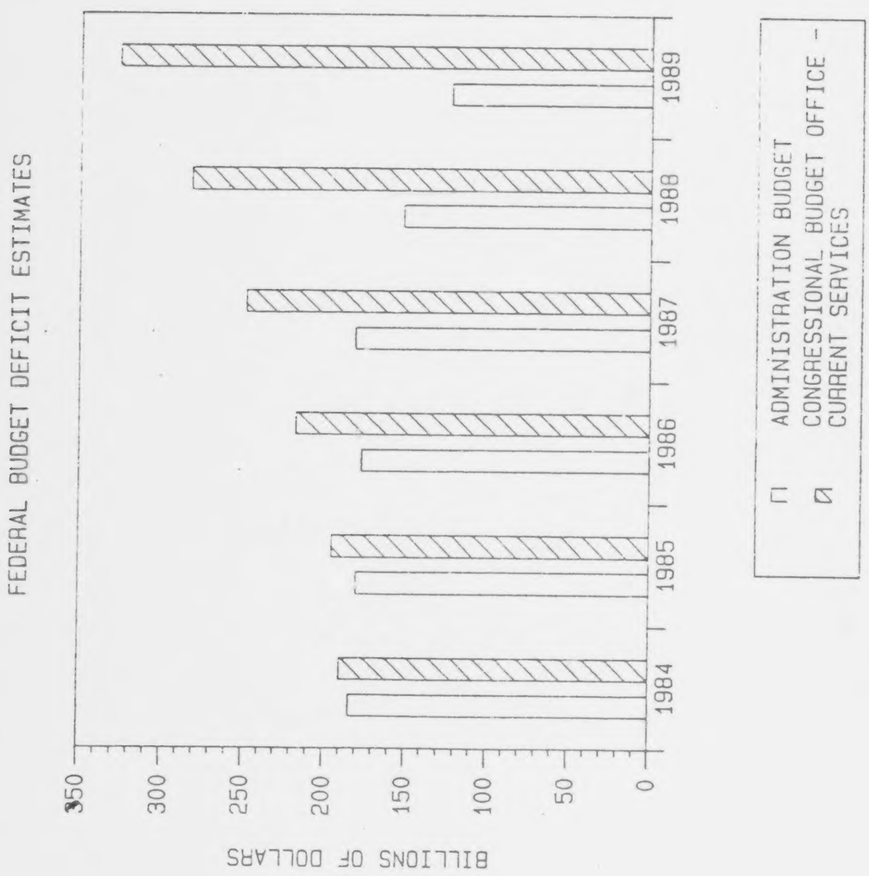
Second, monetary policy during the past year has not been tight. However, real interest rates are high due to high current and expected Federal credit demands. During the next year, the conflict between fiscal policy and monetary policy will grow unless current policies are changed. The likely outcome of this conflict is credit crisis sometime between the Summer of 1984 and early 1985.

Third, the economy has substantial amounts of unused capacity. Current fiscal policies will cause rapid real growth during the next six to nine months. Unfortunately, inflationary pressures will also build somewhat. The best management of the economy would require a more restrictive fiscal policy, combined with a more expansionary monetary policy.

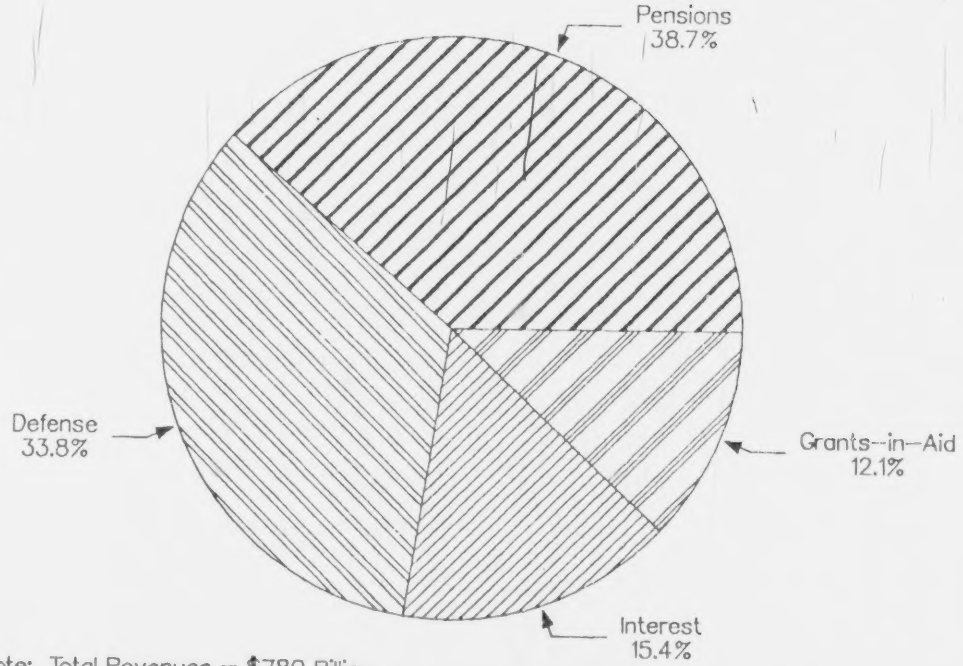
Fourth, a timely deficit reduction could go a long way toward easing the conflict faced by the economy.

Fifth, higher interest rates have a particularly deleterious effect on small businesses because they tend: (a) to be in more precarious financial positions; (b) to have less access to sources of funds; and (c) to have fewer opportunities to hedge against unfavorable interest rate movements.

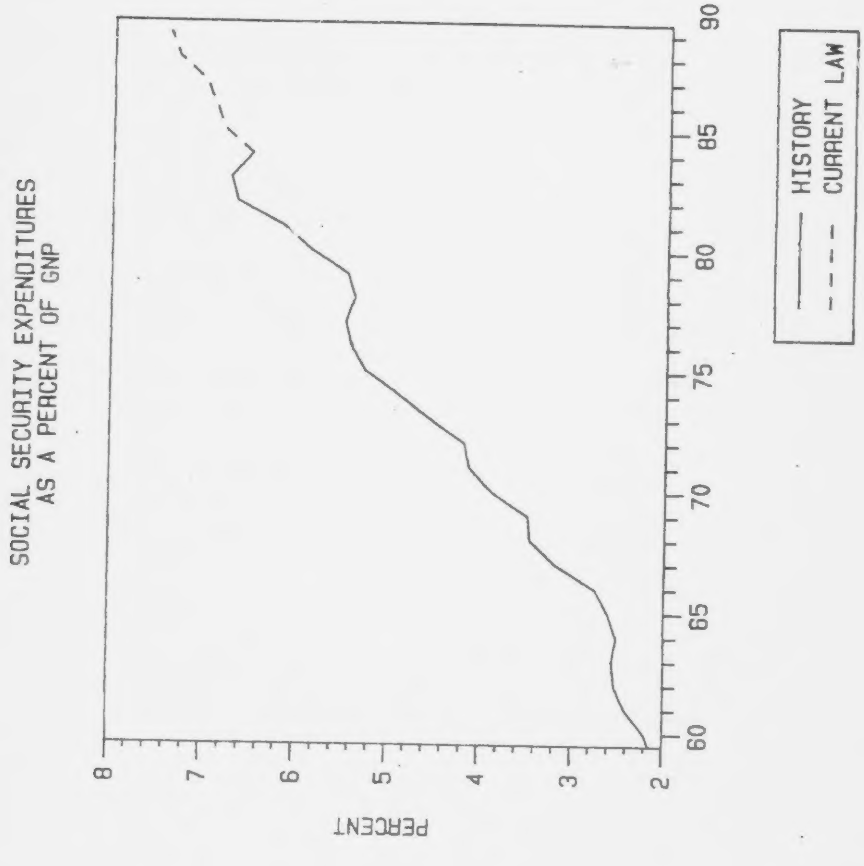
Several exhibits illustrating the main point of my testimony are contained on the following pages.


FEDERAL BUDGET DEFICIT ESTIMATES
BILLIONS OF DOLLARS
0
50
100
150
200
250
300
350
1984
1985
1986
1987
1988
1989
ADMINISTRATION BUDGET
CONGRESSIONAL BUDGET OFFICE - CURRENT SERVICES

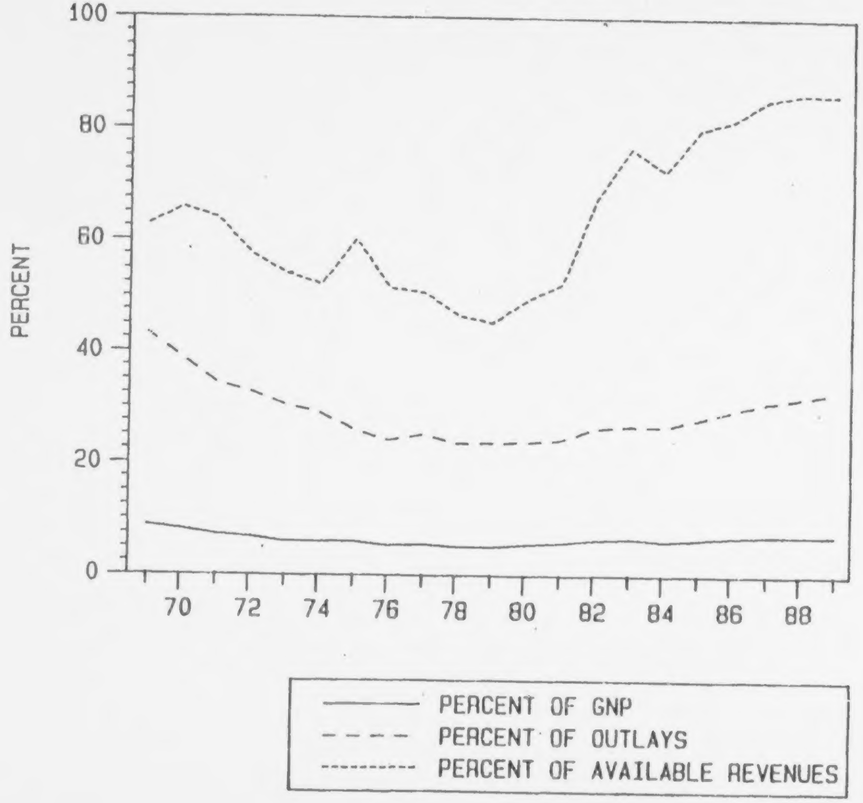
FY 1985 Budget Expenditures Relative To Available Revenues



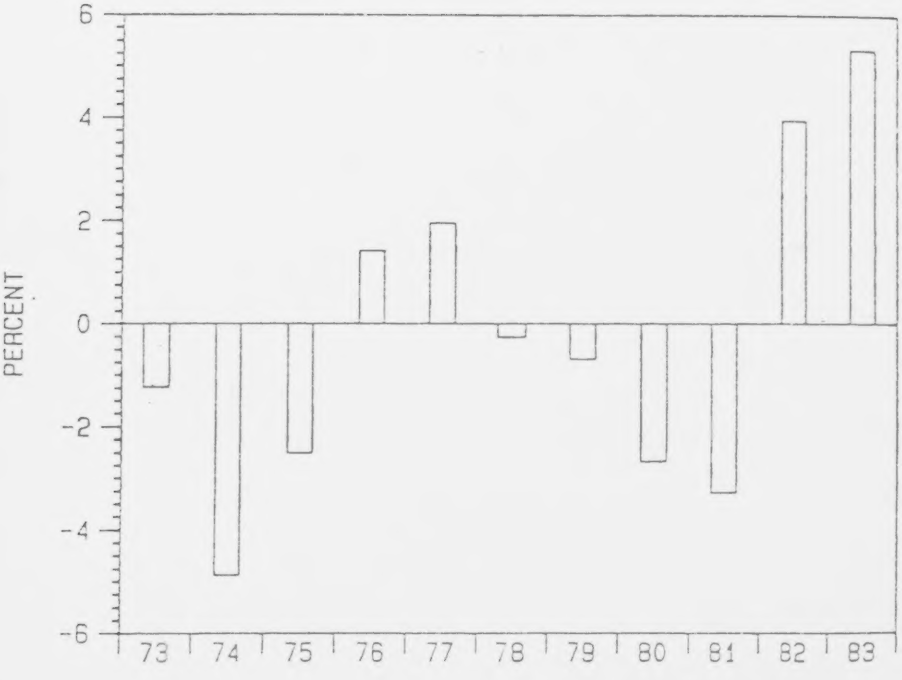
Note: Total Revenues = $780 Billion



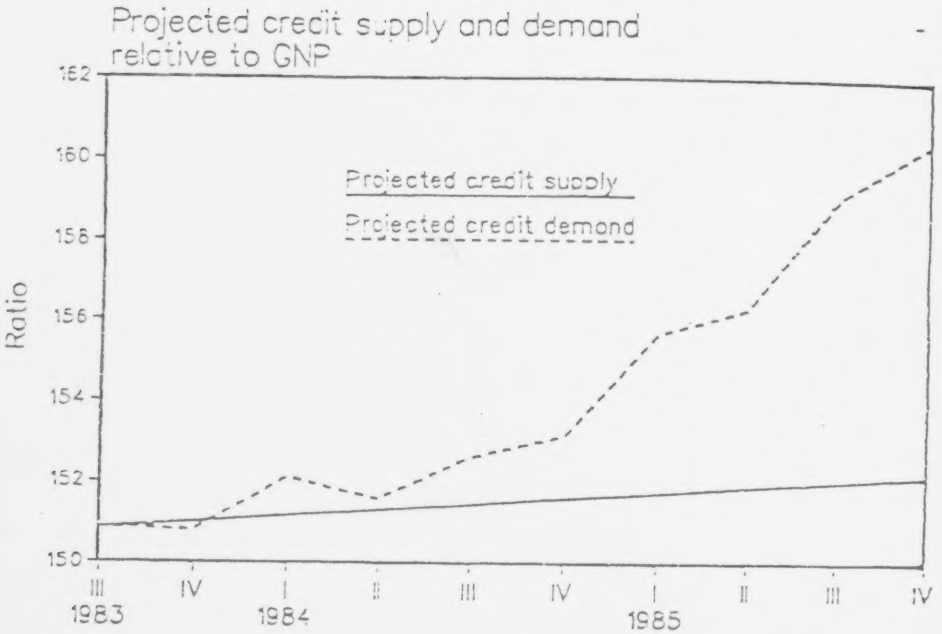
SOCIAL SECURITY EXPENDITURES AS A PERCENT OF GNP



DEFENSE SPENDING PROJECTIONS



REAL M1 GROWTH


Projected credit supply and demand relative to GNP
Projected credit supply
Projected credit demand
Ratio
162
160
158
156
154
152
150
III
1983
IV
I
1984
II
III
IV
I
1985
II
III
IV

The Economic Outlook—Assuming Current Policies

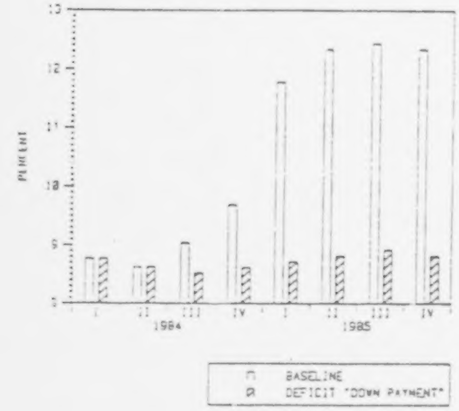
A. The recovery will continue (4% real growth) until 3-6 months after interest rates rise (prime rate above 13%).

B. Inflationary pressures will soon build, and the inflation rate will be greater than 6% by the end of 1984.

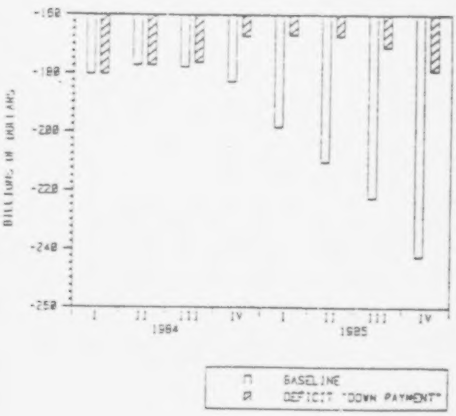
C. The timing of an increase in interest rates depends partly upon small differences in economic developments, partly upon almost random short-term movements in the monetary aggregates, and partly upon political decisions. Our best guess is that interest rates will begin to rise in the late fall—early winter if current policies are not changed. If two deficit reduction "down payments" are enacted, one in 1984 and one in 1985, there is no reason for interest rates or inflation to cause serious problems until 1987 at the earliest.

D. A simultaneous change in policy which reduced both the Federal deficit and interest rates could promote a healthier, and even a stronger, recovery.

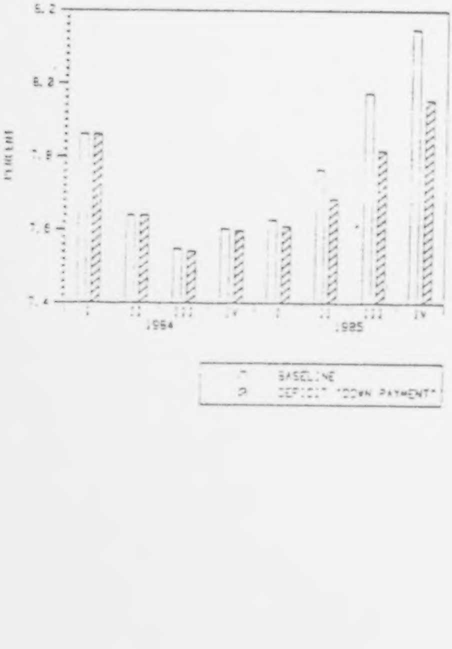
3-MONTH TREASURY BILL RATE



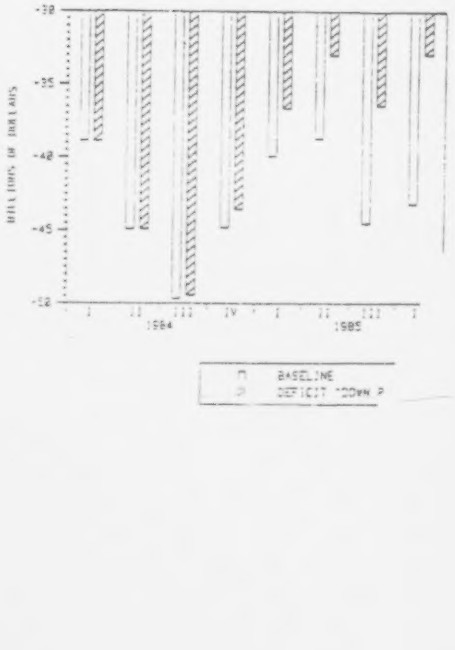
FEDERAL GOVERNMENT SURPLUS OR DEFICIT



UNEMPLOYMENT RATE



NET EXPORTS



BUDGETARY IMPACT OF A DEFICIT REDUCTION PROGRAM

[In billions of dollars]

	1985	1986	1987
Assumed deficit reduction	30	40	50
Assumed 2 percentage point decline in interest rates	20	24	30
Subtotal	50	64	80
Consequent interest savings	3	8	15
Total	53	72	95

Mr. **Mitchell**. Thank you, and I thank all four of you gentlemen for what I think all of the members of the committee will agree is just excellent expert testimony. We will agree that it's excellent. This one member will not agree that he agrees with you in all aspects of the testimony that you have given.

Just two brief announcements before we get into the questioning. As chairman, I want to commend the staffs for the excellent preparation they did for this hearing. It has been just excellent. I want to congratulate you.

I just have one or two quick questions before the first bells ring.

Am I right in assuming that if present conditions obtain, present policies are continued—and you know what policies I'm talking about—we would expect that interest rates for the balance of 1984 would remain pretty much stable, with some increase occurring in the latter part of 1984 and a greater increase occurring in 1985, that is, if the deficit remains relatively unchanged, if the fiscal policies remain relatively unchanged.

Is that a fairly accurate assumption?

Mr. **Straszheim**. We would agree with that, Mr. Chairman.

Mr. **Taub**. There are obvious political reasons why that might happen, and after all, the Federal Reserve Board is not totally independent of——

Mr. **Mitchell**. I always say the Federal Reserve Board is totally autonomous and obviously it would not pursue any policies in an election year that would inure to the benefit of any one given candidate.

Mr. **Taub**. My analysis would lead me to suggest that by the third quarter that situation will be tightening. It is unfortunately beyond our ability to project the exact month that it will occur. But I would begin being concerned in the third quarter.

Mr. **Mitchell**. With the possibility of further increases in 1985, with the same scenario being played?

Mr. **Taub**. Certainly by the fourth quarter of 1984 and early 1985.

Mr. **Mitchell**. Thank you.

Mr. **Bergsten**. I would agree with Dr. Taub. In fact, a number of interest rates have already in the past few months been rising substantially. I would not be surprised to see a steady upward creep through the course of the year. I don't see much likelihood of rates coming down.

Mr. **Mitchell**. My second question area is with reference to your testimony, Dr. Bergsten. I am increasingly interested in export-import and our balance-of-trade deficit. We had Mr. Volcker before one committee and Secretary Regan before the Joint Economic Committee, and I put questions to them about the balance-of-trade deficit. I suggested—and I'm using a loose phrase now—a "de-valuation" of our dollar in the international money markets. Mr. Regan said he did not believe—and I'm quoting him pretty accurately—that he did not believe that the dollar was overvalued, which is an incredible statement for him to have made. Mr. Volcker indicated that he did not anticipate, or he could not see any devaluation of the dollar in the international money markets.

I just think that's a disastrous policy to pursue because it's going to be devalued anyway. According to your testimony, somewhere down the line it is going to be changed, and let's try to approach it now in some reasonable fashion rather than waiting for this precipitous crisis to develop.

You said it may be too late now. Is there nothing we can do with reference to this situation which obviously adversely impacts on small business in a very strong fashion?

Mr. Bergsten. Yes, there are a lot of things to do. Let me just first say, when Secretary Regan and others of the Treasury say that the dollar is not overvalued, they are hiding behind semantics. What they are saying is that the exchange rate is where the market sets the exchange rate, under flexible currency relationships, so how can anybody say it's overvalued if that's where the market set it.

That is why I was careful to define my terms. The term "overvalued dollar" as I use it means overvalued compared with underlying economic and competitive relations among countries. When so defined, I think almost any analyst in the country would agree that it is overvalued on the order of 25 or 30 percent. So it's really a hiding behind semantics to cover some normative judgments and also an unwillingness to do something about it, as you suggested.

But yes, there are a number of things that can be done. Obviously, the most important ones are what we're talking about here; namely, to get the budget deficit and interest rates down. If you can't do that, there are still some things that can be done. For example, over the last few weeks, the dollar has come off a bit against some of the European currencies—not against the yen or Canadian dollar, but against some of the European currencies. In my judgment, that opportunity should be seized by our authorities, through joint intervention in the exchange markets, to take advantage of a market trend which is underway and to push it. I am not a great fan of intervention in the exchange markets as being able to turn basic trends, but when, for temporary periods, as has occurred frequently over the last couple of years, you do get the trend going in the right direction; namely, the dollar coming off a bit—in this case, the German mark and some other European currencies strengthening—the Federal Reserve, under Treasury guidance, and the German Bundesbank and, perhaps, other Europeans should be coming into the market to build on that trend, to push the movement further and try to get the bandwagon rolling in the right direction. That can demonstrably happen. It has been done in the past. I think it is again a missed opportunity.

The yen-dollar rate is the most important in terms of trade competition. We have had two episodes in the past 2 years when the yen has strengthened substantially against the dollar. At both times there should have been joint intervention to push that movement. I think if it had been done in a concerted and substantial way, we might have gotten the yen to 200, 190 to the dollar, instead of it petering out at 230, 235, and leaving quite a misalinement. It can be done.

The final thing, which one does not recommend with great joy, is that if all of the above fails, you may have to manipulate capital flows directly. What is happening, in essence, is that the trade flows are being swamped by international capital movements, motivated by interest rate considerations, the safe haven appeal of the dollar, and other things. Although it is distasteful, one may have to contemplate direct intervention in those capital flows, by which I don't mean direct controls, necessarily. For example, if the Europeans and Japanese were so minded, they could put on what are called interest equalization taxes to offset through a tax on international capital flows the differential between dollar interest rates and interest rates abroad that is motivating much of the flow.

People forget the United States did that for 11 years, from 1963 to 1974, when we had trade surpluses but larger capital outflows, pushing the dollar down. We applied an interest equalization tax to try to limit the capital outflow. The Europeans and Japanese could do that now. It wouldn't be perfect, there would be leakage, but it would help get the currencies moving in the right direction and then, with concerted intervention in the markets, maybe one could get to equilibrium.

So, without going into a lot of details, there are some things that can be done. The administration has refused to admit even that there is a problem, even to contemplate doing anything about it, and I'm afraid that that is making the situation more and more difficult to correct without a real collapse at some point that is going to give us the worst of both worlds.

Mr. MITCHELL. Thank you.

My last question—and I have to give you a little bit of background before I put the question to you. All of you have suggested that we need cuts in domestic spending. That's in the military budget and in other programs. Certainly, if left unchecked, defense spending by 1989 is going to be greater than it was at the height of the Vietnam War. We were spending then about $250 billion annually in constant dollars. It is projected that would be about $300 billion in constant dollars by 1989.

In addition to that, I would like to make point number two, that although I have not been here as long as my distinguished colleague, Mr. Neal Smith, I think we can read the House pretty well. New initiatives are needed in domestic programs, I have some that I would want to push, but I think it's most unlikely that there will be any new initiatives in domestic spending. Therefore, we get down to where we begin to cut in domestic spending.

I feel that there is a kind of consensus developing that on the so-called survival programs there just can be no more cuts. These are the programs that Mr. Stockman alluded to that were cut to the bone under Gramm-Latta. The fact that you have 4 million more people allegedly slipping back into poverty really means that you can't cut further in those types of, what I call, survival programs.

Where do you begin to cut in the domestic programs? Where do you go? Obviously, there is a feeling, I think, on both sides of the aisle that there must be some cuts in defense spending. I think there is that feeling in the Senate and I think you might see that. On the other hand, when we come to cuts in domestic programs, where do we begin this process?

Mr. STRASZHEIM. Let me be the first "victim," Mr. Chairman——

Mr. MITCHELL. Indeed, so.

Mr. STRASZHEIM. This is not easy. There are five major areas in the budget. Defense spending and entitlements payments as Willie Sutton, the bank robber, once said, "It's where the money is." He made that statement in reference to why do you rob banks. That is where the big dollars lie——

Mr. MITCHELL. In entitlements?

Mr. STRASZHEIM. In entitlements and in defense spending. I think there is widespread agreement that a 13 percent real increase in defense spending is not likely to come to pass any time in the foreseeable future. Our baseline has defense spending more on the order of 7 percent in 1985 and even less in 1986. It is entirely possible that the Congress might push those numbers even lower.

In transfer payments, while the Greenspan Commission went some distance 12 or 18 months ago with its proposals, if we're going to reduce the rate of growth in spending, that has got to be a big part of it.

Now, the problem there, of course, is we have in some sense a social contract with people in the private sector who have made good faith planning decisions year after year, that their entitlements would be whatever, depending upon their particular circumstances, and it is not easy to make those cuts. One possibility would be to make something which simply indexed less fully the escalation of those transfer payments.

The other three areas in the budget, grants-in-aid, that's one. I fully realize that every mayor and governor in the country gets upset when the proposal is made to reduce grants-in-aid, but that is one area in the budget that can, indeed, be looked at.

The net interest component is one that is increasingly worrisome now, I think, to many people, because many observers who believe that the interest assumptions in the new budget are overly optimistic believe that those net interest costs are, in fact, going to be even higher. You can't do anything with those directly, other than take the other spending and tax actions which will reduce the deficit and, hence, the net interest payment. Then it is all of those other programs in the budget which need to be reviewed very carefully for any dollars that you can find.

That is not a very satisfactory answer, and not a very optimistic one, but I think you have got to look carefully at all of those areas and get at the job.

Mr. MITCHELL. Thank you. Any other comments?

Mr. BLACK. I have a few suggestions. Hearing what was just said about grants-in-aid and mayors' reactions, I have always felt that perhaps there ought to be a fundamental change and revenue sharing should be called "net revenue sharing." In current times, of course, there is no net revenue because revenues are much lower than expenditures and so there perhaps should be some sort of change there.

But cost-of-living adjustments I believe have been over-generous. I would like to see those reduced. I know I would step on a few toes here, but farm subsidies have been extremely high recently, and even with the PIC program out of the way, they will still be too high, in my estimation. Those impact adversely on consumer prices and adversely on consumers. I think those must be studied with some detail.

Also, one other thing, too. Generally, when we are talking about reductions in expenditures, we are actually talking about reductions in rates of increase, rather than actual reductions themselves. I would like to see more attention paid to actual reductions.

Mr. BERGSTEN. I just wanted to add, Mr. Chairman, I am a signer of the so-called Bipartisan Budget Appeal that was organized about 18 months ago by former Secretary of Commerce Peter Peterson and about a half-dozen Secretaries of Treasury from the past, of both parties. There the focus, in terms of domestic spending cuts, went to what the group called non-means tested entitlements, meaning social security, medicare, veterans benefits, all delicate issues politically, but all where a good deal of the transfer goes not to low-income recipients but rather to middle income recipients. A variety of devices, some of which have already been mentioned, could be put into those programs without impinging on the needs of the poorest members of our society, but with potentially enormous payoff in terms of budget savings, particularly as they mount up over the years.

Now, having said that, I think that one has to add at the end of the day that decisive action of the needed magnitude on the budget is going to have to include a big revenue component. I like to put it in the following terms: some recoupment of the huge tax cuts of 1981. I'm not talking about a net tax increase, going back to an 1980 or early 1981 base, but talking about some recoupment of the massive tax cuts that were voted in 1981. There was a modest recoupment in 1982 and some more recoupment is going to be needed in order to get the overall budget position back in shape.

Mr. MITCHELL. Any other comments?

Mr. TAUB. My only comment is, I would certainly agree with those statements that were made earlier. I think what we really do need is a social compact, where there are two issues. One is the allocation of budgets, and there is no question that we have hit the means tested programs harder than the non-means tested programs in recent years, certainly harder than defense in recent years. So one thing is to allocate exactly how we want our expenditures to go.

The second thing is that we need to do something very serious about the level, and for that we really need a social compact, where we agree that some of it is going to come on the revenue side and some of it will come through defense spending, and some of it will come through the major non-defense spending, particularly these non-means tested entitlements.

I think we are better off getting that question out of the way, with a $120 to $150 billion 3-year bill, and then worrying about how to allocate each dollar after that. I think that might minimize some of the political fallout, too. I don't think our nation's elderly would mind participating in a program where everyone benefitted. The same thing with our Nation's taxpayers. If we're talking about perhaps 3 or 4 percentage points, in terms of increased revenues or expenditures, and we have a much healthier economy, everyone benefits.

Mr. MITCHELL. Thank you very much.

Congressman Daub, and after that we will follow the procedures of the rules. There will be two Democratic members called on and then one member from the minority.

Congressman Daub.

Mr. DAUB. Thank you, Mr. Chairman.

I am most engaged by your testimony. I wish I had 5 hours with the four of you in a room by yourselves. The first question I would probably ask is what's the stock market going to do next year, which is about the only thing we haven't touched on relative to your expertise, gentlemen. I am most impressed and you have added a great deal of constructive testimony. I suggested to our very influential committee chairman that, in fact, he call you before his other committee, the Banking Committee, where they need to hear what you all have said.

The Gramm-Latta tax cuts amounted to a projection of revenue reductions across the board for 8 years totaling $1.138 trillion. When you look at bracket creep, which has taken back already, until indexing may occur in 1985, $438 billion of that, and when you look at the tax increase in 1982, which took back $281 billion of that, and you look at the social security FICA rate against base increases that occurred, and you look at the 21.5-cent gas tax and you look at a whole bunch of other things that have occurred, there is about $77 billion left of that so-called tax cut spread over 8 years, which makes the revenue loss to Treasury less than $10 billion a year from Gramm-Latta I and Gramm-Latta II.

So we have our deficit now from $200 billion, let's take it down to $290 billion. Then we could maybe talk about defense in real terms, next year's total purchases of add-ons, probably the same as what Carter would have done if you look at his budget carefully in real terms, add another $8 billion, maybe, if you got rid of all those things, we could save $8 billion. So we are now down to $181 billion worth of deficit that is there and would have been there if the scenario had not changed.

What about oil prices? Nobody has mentioned world oil prices. If there is not an Iran-Iraq war, might oil prices drop further than they are now? If, in fact, oil prices dropped, does that have an impact on inflation rates, and then would your 6-percent figure be more like 4 by the end of the year? And what about this liquidity in banking? I mean, banks are 45 percent liquid today. They have more money than they know what to do with tucked away in all their accounts. Would that have an impact, with so much supply against a limited demand because of profits the last 1½ years? Would that mean that, in fact, against all of your predictions, all of you except Professor Black, would that mean that, in fact, you're all wrong again, for the third year in a row, that we will have declining interest rates?

Mr. **Bergsten**. I can perhaps answer more objectively, because I don't make forecasts of interest——

Mr. **Daub**. But you see what I'm getting at. You know, nobody mentioned oil prices, everybody says take back some of the tax cut. Take back what? There's nothing left to take back. I'm a little bit baffled by all of this backward, historic redetermination when, in fact, we've got bag and save and Burgur Biggie and high tech and robotization and computerization and a shift to an aging society, the demographs have switched. I don't know if you've retuned your computers yet. You're not looking at the new base out there that's going to produce taxes.

Mr. **Bergsten**. Just on the tax side, I was careful to say a recoupment of revenues, by which I meant not that there had been a big net tax cut, only that there had been a sharp reduction from where revenues would have to be in order to pay for the big increases in spending that have been put in place net.

Mr. **Daub**. As we all know, there would have been 4 million less taxpayers and 4 million net taxeaters, too, if this stimulus hadn't occurred by using the deficit to do it.

Mr. **Bergsten**. Right. It would have been even more, I agree. But, on interest rates you said the point was made earlier that interest rates have dropped. There the real question is about the level of real interest rates and how one measures real interest rates and whether one believes that's the most important analytical device. I happen to believe it is.

The simple statement that interest rates have dropped from 20 to 10 percent is not, to me, terribly relevant if inflation, as it did during that period, dropped from 15 to 3 percent. Then real interest rates are higher today than they were in the base period.

Mr. **Daub**. I agree, but I'm looking at——

Mr. **Bergsten**. I simply want to make the point, when you say the forecasts have all been wrong and those who said interest rates were going to be high were wrong, it depends on what interest rates you mean.

Mr. **Daub**. Let's use the political problem as a base, because I think we all agree that that's where we wrestle here with your input. You don't need to venture what the political decision will be. Just that if, in fact, you look at these things, whatever the definition, rates were perceived at 21 and they're now perceived at 11. Inflation in the last quarter, in the 1980 time frame, 17, and it's now 3.2. There were 3 months last year when we had negative inflation, if you want to call it that. We had decapitalization, and we still have it in farmland and in some other things in the economy.

So if, in fact, that is true, what about the world we live in? Does the oil price, if there isn't a war between Iraq and Iran, and the Straits of Hormuz aren't closed—you know, all the Saudi oil emirates learned what America did. They got so much money in that they established a Federal budget, and now they're spending more than they take in, and now they've got to ignore the OPEC price and they've got to sell their oil short to get cash because they need the money. So if oil prices go down 4 or 5, or maybe even 2 or 3, won't that keep our inflation rate at 3 for the year? Won't that mean more corporate profits? Banks are awash in cash. They're only looking for good loans. That's what keeps that rate, I agree, at 13.

Isn't it likely that this year is going to be an even better year relative to these indexes? We've got 4.4 hours of overtime being paid for every 40-hour job in America. There is still unutilized plant capacity and there is still obviously a drop in unemployment to the 7.2-figure by the end of the year, maybe.

Mr. TAUB. You're right, if we want to make our economic policy based on a solution of the Iraq-Iran war, we certainly can. If there is a solution to the war, the world is flooded with oil, oil prices will come down, inflation will come down, and it will buy us another 6, perhaps 9 months. Is that the way we want to make policy?

Mr. DAUB. Well, I'm not sure. I only asked you a question. I didn't even assert what I believe. I'm trying to be Morris West. You know, he wrote a book called "Devil's Advocate," and I'm trying to ask you what you think about some factors that I don't see anybody talking about. Net disposable increases relative to the growth in entitlements, I don't see a chart from you, for example, that talks about what's left. You talked about defense and the usable dollar, but you don't have a chart that relates to. * * * The tax cuts, the CBO said, in 1981, we're going to see revenues grow from 1981 at $600 billion to the Treasury, to 1986, $900 billion revenues to the Treasury. That's going to happen. We're going to take in that much.

What are you guys telling us about what's happening in this economy, that's what I want to know. Tell us what's happening, if you know.

Mr. STRASZHEIM. Mr. Daub, you may quite well be right, that we are wrong again on our economic forecasts. The interesting thing about the future is that it is the future and it will continue to be so.

With respect to oil prices in particular, one viewpoint is that oil prices might decline another $4 or $5. That is not our viewpoint. Our viewpoint is that as the U.S. economy expands in 1984—and you have pointed out well that it has been expanding very nicely—the U.S. demand for oil products and energy products in general will rise and will rise substantially.

Many of the other industrialized nations in the world are beginning to pick up a bit as well. Their demand for energy products will start to rise as well.

Mr. DAUB. Let me insert one thing. Net Federal borrowing for the first 4 months of the fiscal year was down compared to a year ago.

Mr. STRASZHEIM. Yes, indeed. The difference there is precisely that the economy is starting to do better.

But if I could go back to the oil question and then return to the borrowing issue, as the economies across the world pick up, we think energy demand will pick up. That will begin to lift oil prices, not push them down.

With respect to net Federal borrowing, less now than a year ago, indeed, that is the case and that reflects the economy which is stronger, better taxes, less unemployment compensation, 10.8 unemployment now down to 8, and so on and so forth. The other element, however, is that as the private sector of the economy heats up with the total economy, private sector demands for credit will begin to rise as funding of inventories is required. That hasn't begun to pick up appreciably as yet, but it is our expectation that that will.

The nonresidential fixed investment sector has done very nicely. As the corporate profit gain starts to slow, as the second year of the economy growth rates will be slower than in the first, that profit throwoff will begin to slow. You will start to see rising private sector demands for credit. So while it's true, that the public sector demands for credit are lower in the first 4 months of this fiscal year than last, that will be more than offset by an increase in the private sector demands for credit. That is why we see an gradual upcreep in interest rates across this year, and more so in the next.

Mr. **Mitchell**. The gentleman's time has expired.

Mr. **Daub**. Mr. Chairman, I know my time has expired. Let me just say in final comment that let's engage ourselves throughout the year, Mr. Chairman, with these kinds of witnesses. I just want to compliment you again, and staff, for what we have done.

I would say to you, I don't know if I hope you're right or I'm right or a mixture of the two, but I do know that we need this year to really make progress, as you all have suggested. So thank you for your contributions today.

Mr. **Mitchell**. We will now proceed under the 5-minute rule. Congressman Smith.

Mr. **Neal Smith**. Dr. Bergsten, can you quickly summarize this. You said something about the Federal Reserve under Treasury guidance. How does the Treasury guide the Federal Reserve?

Mr. **Bergsten**. Under existing law, the Bretton-Woods Act of 1946 to be precise, the Secretary of the Treasury has responsibility for the international monetary policy of the United States. So when the Federal Reserve, as the operating agent, intervenes in the exchange markets, which was the point I was referring to, it does so under policy set by the Secretary of the Treasury.

Mr. **Neal Smith**. Dr. Taub, you said, "If the Fed will let interest rates decline 2 percent." That implies that they could. Are you saying the Fed does have some control of interest rates?

Mr. **Taub**. I believe that Chairman Volcker has, indeed, already testified that if there was a major Federal deficit reduction program, he could simultaneously pursue monetary policies which would allow interest rates to fall 2 percentage points.

Mr. **Neal Smith**. Well, that implies that he could if he wants to anyway, couldn't he?

Mr. **Taub**. Yes, he certainly could.

Mr. **Neal Smith**. The reason I ask is that Secretary Regan a few days ago told us the Fed can't control interest rates, that it's just supply and demand.

Mr. **Taub**. Yes, but they supply the money.

Mr. **Neal Smith**. That's right. I agree with you, but I just wanted to bring that out.

I want to know about the forecasters here. I don't know how you can make a forecast when you don't know what the Fed policy is going to be. We don't even know what it is today. I mean, since the last open market meeting, we don't know what the Fed policy is.

They'll tell us a few weeks later. So how can you make a forecast when you don't know what the Fed policy is, if they can control interest rates to the extent we just said.

Mr. **Straszheim**. Congressman, you are quite right in pointing out that this forecasting business is not easy. Indeed, while we don't know what monetary policy will be, nor do we know what fiscal policy will be. That is perhaps one of the difficulties of forecasting. But we simply have to make assumptions about the conduct of monetary policy——

Mr. **Neal Smith**. Are you assuming that monetary policy will not change, like it did 3 times in the last three years?

Mr. **Straszheim**. In our current baseline forecast, we are assuming that monetary policy will gradually tighten as the economy picks up later in 1984, continues to rise in 1984, and as the economy starts to gradually close on full employment.

Mr. **Neal Smith**. I was on the Budget Committee in 1975 and I remember at the time we were told the budget deficit is going to go up to the highest it has ever been, $65 billion. It sounded like a terribly large figure compared to the $20 and $30 billions we were used to. They said interest rates will go down.

Now it is just a law, you know, out in chamber of commerce meetings and everywhere else, that if the deficit goes up, interest rates go up. But lo and behold, that's exactly what happened. The deficit went up and the interest rates came down because the private sector didn't use the money and there was more money available to finance the increase in the deficit because the private sector used so much less. Then we examined it and we find that's the way it works in all recessions—until we came to this one. But we came to this one—and I hadn't heard any discussion of this and that's the reason I bring it up—we came to this one at the point where the deficit went up and the private sector quit borrowing money, and that was more than enough to accommodate it. Ordinarily, then interest rates start to fall because there's still some extra money out there.

But at that point the big banks decided to loan a lot of money overseas, and then sell participations all over the country, $90 or $100 billion of it. The money was loaned, the money was sucked out of places like Iowa, because they could send it in here and get 3 percent more than they could loan it to a local small businessman. That couldn't help but to extend the recession further and further. But I didn't hear any discussion of this. Didn't this $100 billion or whatever it was have some effect of aggravating and extending this recession?

Mr. **Bergsten**. Just to make one point on the loans abroad, I think there was clearly some deflection. However, you have to remember there was also a big new infusion of deposits in those banks from abroad, because this was after the second oil shock. The balance-of-payments surpluses of the OPEC countries, which had disappeared in 1978, again rose sharply, causing them to deposit the so-called petrodollars in the banks, who then recycled, as we then called it, on to many of the debtor countries in the——

Mr. **Neal Smith**. But then when the recession continued, then they can draw that out. Then our economy starts to suffer even worse and that extends the recession even further, doesn't it?

Mr. **Bergsten**. But again, it's happening on both sides. As you know, because of the debt crisis in those developing countries, the banks are cutting back very sharply on the growth of their new lending there, in some cases even withdrawing funds net.

Mr. **Neal Smith**. I know that money came out of the rural areas at a time when local banks could have loaned it locally for 12 percent, where they wouldn't loan it, and ordinarily that would have helped to bring us out of the recession.

Mr. **Mitchell**. The gentleman's time has expired.

Congressman Hayes.

Mr. **Hayes**. Mr. Chairman, just let me express my appreciation for your generosity in permitting me to raise a question, because I'm not really a member of this subcommittee. I am in a learning process; I want to make that clear here. When you talk about big dollars, as is the case here, I weigh that against my own district in which food stamps are a medium of exchange to a large extent.

The thing that really bothers me—and I would like one of you gentlemen who have given excellent testimony to maybe embellish on it a little bit—what impact do you see the reduction in unemployment having on our Federal debt. I have been of the opinion that an increase in the consumer market for goods and services, which is a source of creation of jobs, could have a favorable impact on our whole economic situation. I'm not concerned about a play on numbers, as I think is the case to some extent. When you talk about reduction of unemployment, people are lost once they exhaust their collection of fixed benefit programs.

I see a situation now where conceptually there is going to be 7 or 8 percent unemployment figures as being full employment to some extent. In other words, there could be people permanently unemployed, which sort of creates a feeling in my mind that we are never going to get back hardly to where we were. For example, you mentioned the impact of profits on helping to reduce the deficit. I noticed this year that General Motors, this big giant of a corporation, showed profits of something in excess of, I think, $2 billion. But at the same time they have less people employed than they did before. The same thing is true with Ford. The impact of technology on jobs and the elimination of jobs is certainly going to create a situation where we have less jobs and more people looking for jobs. How is this going to affect our overall economic situation as it relates to the Federal deficit?

Mr. **Black**. Let me take a stab at that.

First I believe that currently what we are seeing is some basic structural changes in the economy. I agree with you, that in many industries, particularly in heavy industries, jobs are disappearing. Those jobs have disappeared forever.

But I do believe we are seeing jobs being rechanneled into other areas. What we are going through now is this current state of transition. We get to these periods historically in which we have individuals who say that because of changes in technology there are going to be these permanently large pools of unemployed individuals. It hasn't happened in the past, and I am optimistic that it's not going to happen in the future.

There is one thing, though, and that is, if we do look at those people who are, if you will, permanently unemployed, permanently displaced, you have to ask the question, "Do we have in place policies that aid in encouraging those individuals to become productive, to get back into the workplace, to acquire the new skills necessary in order to work." I believe that currently we could probably answer no to that.

Mr. TAUB. Mr. Hayes, I am as concerned as you are that we have changed our standards for the economy in recent years; that is, there is a complacency now that policy isn't so bad because, after all, the prime rate is only 11 percent and the unemployment rate has fallen to 8 percent. But these are not good numbers. I would, in fact, like to try to convey a sense of urgency in fixing economic policy to the members of this committee.

Mr. BERGSTEN. Just on your specific question—my colleagues can check me—I think there's a rule of thumb that says for every percentage point of decline in the rate of unemployment, the budget deficit tends to be reduced by about $30 billion, as a result of higher tax revenues and lower expenditures on income maintenance programs. Others can correct the details. That's not my expertise. But I think there is a rule of thumb along those lines.

Mr. TAUB. The sad thing is, we have already incorporated reductions in unemployment into our baseline forecast.

Mr. MITCHELL. The gentleman's time has expired.

Congressman Boehlert.

Mr. BOEHLERT. Thank you, Mr. Chairman.

I agree with my senior colleague on this side of the aisle. This is a particularly productive hearing and I appreciate hearing the testimony and a good give-and-take.

You know, there are three certainties in life—death, taxes, and Congress wanting to spend more money, especially in an election year. We all have to be scared by that. If we eliminate all discretionary spending from the budget, we are still going to have a pretty sizable deficit. So obviously, we have got to look, as you have suggested, at some of the entitlement programs, and we have to look at the possibility of raising revenue.

I guess one of my principal questions is, do you think Congress has the guts to do what has to be done in terms of raising revenue? Perhaps the best example I can think of, of Congress completely caving in, occurred last year when we repealed one of the provisions of the Tax Reform Act of 1982, specifically the 10-percent withholding on interest and dividends. There were only 41 of us who voted not to repeal that, and as a result we have a revenue loss of somewhere in the neighborhood of $7 billion a year, probably conservative.

Do you think Congress has the guts to deal with the job and the manner in which it has to deal with it?

Mr. MITCHELL. Will the gentleman yield?

Mr. BOEHLERT. Certainly, Mr. Chairman.

Mr. MITCHELL. We have all alluded to the technical competence and expertise of the witnesses before us. Is the gentlemen asking these witnesses to be omniscient? [Laughter.]

Mr. BOEHLERT. No, Mr. Chairman.

Mr. BERGSTEN. I thought he was just saying "turn about is fair play." You have made lots of comments about the accuracy of the forecasters. We might as well comment on the guts of the politicians. [Laughter.]

Mr. **Boehlert**. Dr. Black, I have something specifically for you in a moment.

How about the Grace Commission report? We have heard so much about that, much ballyhoo. I think the figures are grossly inflated on projected savings. But do any of you have any specific comments on any portions of the Grace Commission recommendations?

Mr. **Straszheim**. We have not looked at that with great care, Mr. Congressman. But in the looking that we have done, we agree that the numbers are many orders of magnitude larger than we think is likely to be achieved. Many of the savings there are not closing the window so you don't heat the outside, turning off the lights and so forth, the kinds of costless sorts of savings, but rather many of them require legislation. It seems to be stretching a bit to call those, in certain cases, at least, savings of $424-odd billion over that course. It isn't at all feasible in our view.

Mr. **Boehlert**. Any other comments on the Grace Commission?

Mr. **Daub**. Will the gentleman yield?

Mr. **Boehlert**. By all means.

Mr. **Daub**. Would you check it out in the next 3 or 4 months, and if there is a dollar or a dime in there that you think is fair, would you say so? I mean, there's a $58.7 billion recommendation, I should say to my colleagues, simply on military pension reform. Even if it's only $100 billion or $90 billion, the policy initiative that they suggest may be worth it, but their figures may be grossly inflated. But the fact of the matter is, if there is something in there, would you check us out and let us know?

Mr. **Straszheim**. We would be glad to, Mr. Congressman.

Mr. **Boehlert**. The other side of the equation, in addition to cutting spending, is to raise revenue. There are a number of ways to raise revenue. You don't necessarily have to increase the tax rate. You can collect the taxes already due the Government, and I use that 10 percent withholding as a prime example. We weren't raising anyone's taxes. We were saying to those people who owed money to the Government on income earned that we would like to see that money in the U.S. Treasury.

There is an estimated $100 billion underground economy. How do we tackle that? How do we get the revenue into the Treasury that is owed to the Treasury? Do any of you have any particular thoughts on that?

Mr. **Taub**. Yes. In answering both questions, there are lots of recommendations of the Grace Commission that we could enact. For example, we know that every dollar spent on the IRS returns somewhere between $5 and $10 of additional revenue. These are taxes owed but not paid. Interest dividend withholding is a perfect case. It doesn't affect poor people; it doesn't raise taxes; all it does is collect taxes that are due. It is hard to understand how we can talk about not being able to find any money at all when we let these huge loopholes go through.

Mr. **Boehlert**. Dr. Black?

Mr. **Black**. I am always concerned about cost. I didn't see the figures as far as withholding is concerned, but how much would that have cost the institutions to comply? Would the net benefit have been worth it? It's just a question for me.

Mr. BOEHLERT. The answer is it would cost next to nothing for the institutions. For a major, major banking institution in America, it cost $3 million to get everything in place, which was a drop in the bucket compared to its overall expenditures for day-to-day operations, and the irony of the whole thing was they had to go through with the expenditure while they were engaging in a campaign to lobby the Congress, so they spent the money but we didn't get the result we were after.

The Chairman has advised that my time is up, but I would like to say to Dr. Black particularly, I would like to talk to you after this about individual training accounts. I want you to be aware that we're doing a new initiative to establish individual training accounts for displaced workers, a fund for them to acquire new skills, so that they're not going to be displaced for very long. I will give you some information on that.

Mr. MITCHELL. Mr. Luken, do I understand you do not have any questions at this time?

Mr. LUKEN. Mr. Chairman, can I have 1 minute?

Mr. MITCHELL. Sure.

Mr. LUKEN. I was unable to be here for all the testimony, but I would like to direct a question to Dr. Bergsten. I have tried to read quickly through your testimony, which is excellent, and I find myself in agreement with it. I just wonder, though, you did mention, with reference to our international trade and the foreboding prospects, a factor which I believe to be there—and we'll hear something from other witnesses today—of the practice of importers targeting the American market or targeting particular markets, utilizing their favored tax position, subsidies, at perhaps less than fair trade aspects.

Would you want to make any comment about that? Do you feel that has any impact at all?

Mr. BERGSTEN. I think it has some impact. In my own institute we are analyzing a number of cases where one can find that. We are doing work on specific sectors to look at that.

It does happen and, when it does, the remedy is very clear. Under U.S. law, we have countervailing duties that we can apply against foreign subsidies, wherever it is determined that injury is caused to American firms and workers. We have antidumping duties that we can apply in response to dumping practices by foreign suppliers. We have a panoply of legal remedies that American firms can use when they are unfairly hit.

Now, in practice, those sometimes take time to run through, and sometimes it is hard to discern what the foreign practices are. Therefore, you want to always be negotiating those practices away. In the Tokyo round, in the late seventies, we negotiated a whole subsidies code that at least begins to put some sharp limits on the subsidy practices that other governments can use to promote their exports, and on our own, I might add, because we're not clean handed in this process. So there are unfair trade practices. People are always trying to stay one step ahead of the judge, so we must be very nimble to cope with them.

However, having said all that, my own judgment is that the amount of trade that is occasioned by those practices is miniscule in comparison to what we are losing as a result of the overvaluation of the dollar in the exchange market. I suggested that, purely from a conservative estimate of dollar overvaluation, we have shot ourselves in the foot to the tune of $75 to $100 billion worth of trade balances. It may be that some modest fraction of that can be accounted for by foreign unfair trade practices, but I really don't think it's more than that.

Mr. **Luken**. Thank you, Mr. Chairman. Thank you, Mr. Bergsten.

Mr. **Mitchell**. Congressman Molinari.

Mr. **Molinari**. Dr. Straszheim, in your testimony you mention that the tax receipts are not as large as expected. I assume you're talking about on a Federal level there, are you not?

Mr. **Straszheim**. Yes, sir.

Mr. **Molinari**. What about with respect to the anticipated revenue figures with local government? For example, I'm from New York City and we have a half-a-billion dollar surplus in New York City, and there's a great controversy about the fact that the State may or may not have a hidden surplus of a billion dollars. We hear in California the contrary, their predictions that they're expected to have a very substantial deficit. I am seeing all over the country local governments bringing in much larger tax revenues than were anticipated.

Could you comment on whether that is accurate or whether these are isolated cases I have heard about.

Mr. **Straszheim**. Yes, Mr. Congressman. I think they really are not isolated cases. The intention of that statement is to make the rather general point that there are three basic reasons why budget outcomes in various years come in less favorably than had been anticipated, the first of which is the point on tax receipts not being as large as expected. I did not mean for that to apply to any particular year, but rather, made that as a general statement.

With respect to the State and local revenues, I think it is, in general, the case that State and local receipts have been higher in the last year than most people had anticipated, econometric forecasters, State legislators and the like. I think the reason for that is that the economy has done better in the last year than people had anticipated.

As a consequence, the very rapid increase in employment, 4 million more jobs, those people make incomes, pay taxes, they consume and pay sales taxes and the like. So I think that is the reason, that the stronger economy has given the better tax throwoff.

Mr. **Molinari**. I would like to make a comment before the next question. Unlike my colleague here on my right, Congressman Boehlert, I suspect that if we do have some tax measures that come before the House of Representatives, you're going to see some of the folks there falling all over themselves to vote for them. I don't see much of a problem there. The spending cuts is where we're going to have the guts problem, not on raising taxes.

It is amazing to me, at least, how the "yes" buttons go up so quickly when there's a tax measure on the Floor of the House of Representatives.

The statement was made, also by yourself——

Mr. LUKEN. Would the gentleman yield? Do you mean on a tax increase?

Mr. MOLINARI. Sure, if you want me to yield. I'm sorry, I didn't hear you. Do you want me to yield to you?

Mr. LUKEN. Yes. Would you yield?

Mr. MOLINARI. Sure.

Mr. LUKEN. Is the gentleman saying that when a tax hike comes on the Floor that the "yes" buttons go up automatically?

Mr. MOLINARI. I say that there's a certain percentage of those in the House of Representatives that will vote very quickly "yes," yes, sir. That's what I'm saying.

Mr. LUKEN. Oh, percentage.

Mr. MOLINARI. Not all of us, no. Not all of us.

The statement was made that small business—and that's what we're talking about here—small business will fare as well as the general economy. The observations have been made today that, at least until now, the general economy is faring quite well. We're in a pretty good part of the economic recovery, and there is some speculation as to how long that is going to last.

Can we say that the small business community is doing rather well, as the large industries are doing? Is there a distinction to be drawn?

Mr. STRASZHEIM. I think perhaps it's a bit of an overstatement to say that small business will do as well as larger business, because some of the larger businesses, manufacturing in particular, which were so devastated in the 1980–1982 recession, and were so badly hurt by the problems internationally, have indeed come back substantially, albeit not to healthy levels as yet.

Small business, in general, I think has participated very nicely in the 1983, early 1984 recovery, but they continue to be hurt very badly, perhaps more so, than large businesses by the very high interest rates. They are, indeed, as has been pointed out before, very sensitive to interest costs and borrowing and they don't have the cushion available that large businesses do to sustain them through these rough times.

Mr. MOLINARI. My time has expired already. One last quick question, if I may.

On table 2, where you talk about economic assumptions, you made a statement that the assumptions have been markedly off from those that were projected by the various administrations. I have looked at the actual as opposed to those that were assumed, and not tryng to be partisan, but in 1983 the assumption forecast was 3.3 percent growth and the actual was 3.3 percent. The year before, minus 1.8 percent and the actual was minus 1.9. If you look back somewhat, you see some substantial differences. But in the last few years it seems like the percentage of the Gross National Product has been fairly close.

Is there something I missed in your presentation?

Mr. MITCHELL. Before there is a response, let me indicate to my colleague that there are seven more witnesses——

Mr. MOLINARI. That's my last question.

Mr. Mitchell. Unfair as it is, I am going to have to try to strictly adhere to the five minute rule, including the application of that rule to myself.

If the panel wants to respond to his question, fine.

Mr. Straszheim. Mr. Chairman, let me respond very quickly.

The principal point behind table 2 is as follows: the economic forecast in the current year and one year out, in general, it seems to us, whether it be from Republican or Democratic Presidents embedded in budgets, has, by and large, been quite accurate.

The second part of that point is in years 3, 4, 5 and 6, in the outyears, both Republican and Democratic Presidents, it seems to us, have embedded economic assumptions which have turned out to be more optimistic than the final outcome.

Mr. Molinari. Thank you.

Thank you, Mr. Chairman.

Mr. Mitchell. Thank you.

Gentlemen, thank you very much. Obviously, we have additional questions. You can't just sit here and hear testimony like that without having formulated additional questions. Would you agree that if we submit additional questions to you in writing, will you try to respond to them?

Mr. Straszheim. Certainly.

Mr. Mitchell. Thank you very, very much, gentlemen, for your excellent testimony.

Our next panel consists of Joseph Duncan, chief statistician and corporate economist with Dun & Bradstreet Corp.; William Bradford, professor of finance, University of Maryland—which is of significance to me—and currently a visiting professor at Yale University; and Travers J. Bell, Jr., chairman of the board, Daniels & Bell, Inc., New York Stock Exchange.

Gentlemen, if you will come forward, we will proceed with your testimony. I understand that Mr. Duncan has to leave immediately after his testimony. We will proceed with taking testimony of all the members of the panel, and then put questions to you.

Mr. Duncan.

TESTIMONY OF JOSEPH W. DUNCAN, CHIEF STATISTICIAN, THE DUN & BRADSTREET CORP.

Mr. Duncan. Thank you, Mr. Chairman.

My task is a little easier than the preceding panel, in the sense that rather than making a forecast, I would like to present to the committee some statistics that are current data about the pattern of business failures, particularly small businesses, so that you have a little additional perspective on the nature of current trends.

In the preceding panel you referred to a chart which showed the sharp increase in the number of business failures and, of course, that is Dun & Bradstreet data and is an accurate chart. What I would like to do, however, is look in a little bit more detail at the latter part of that chart, that is, what happened near the end of 1983.

I will not read my testimony, Mr. Chairman. I will summarize it. The detailed statistics are in my prepared remarks.

Mr. **Mitchell**. Without objection, your entire testimony will appear in the record.

Mr. **Duncan**. Let me refer to the chart that is now sitting next to your chart and comment on the pattern that occurred in the latter part of 1983.

We revised our data collection procedures last year, about midyear, and therefore, in order to maintain consistency in the data, we have developed a new index on the basis of a 5-week moving average—that is, the average of the preceding 5 weeks.

In my prepared remarks, on table 2, you will note that the index has been fluctuating near the 100 level since it was initiated in October 1983. It was set as 100 to provide us with a statistical basis for splicing the new and old data together.

What is important in that table is not the week-to-week movements but, rather, the fact that the total level of business failures seems to have reached a plateau in the fourth quarter of last year. As you can see from the data, it is continuing on that plateau into this year.

You will note in the table that the index declined in January. I would like to explain that. Near the end of the year there appears to be a tendency for businesses that are in difficulty to hold on at the end of the year, hoping that maybe something will happen. A lot of these firms are in the retail sector and we had a very strong retail season last December. We found that the actual level for 2 weeks in December was one-half of the average level of the preceding months. Consequently, that brings the average down. So I look at that as a seasonal factor, not a significant decline in the number of business failures.

You can get a sense of the pattern by looking at the index on the basis of what would the index have said last year and the year before. If I had used the same procedure for calculating the data in 1982, the index for the second week in February, which was 96.5, would have been 135.4. And in 1983, the index would have been 148. In other words, we have come out of 2 years of rapidly accelerating levels of business failures and it does now appear that, in fact, there is a plateauing of those failures.

It is quite clear that a major number of business failures are smaller companies. In fact, it is rather remarkable that some of the failures involve really a very modest level of outstanding liabilities. Table 3 of my testimony shows that over 10 percent of the business failures involved less than $10,000 of outstanding liabilities. It is also true, of course, that between 7 and 8 percent of the failures involve over a million dollars, so there are some very big companies involved in failures as well.

The other tables in my prepared testimony present some information on the industry of the companies that have failed, the region, and in both of those tables it shows that at this point in time we don't have business-cycle related characteristics as was true during the recession. For example, when the construction industry faltered, the percentage of construction-related firms was extraordinary. When the decline in oil drilling activity occurred, we saw a lot of failures in that area. Now the failures seem to be relatively stable on a month-to-month basis in terms of industry structure, in effect reflecting the fact that there are large numbers of firms in sectors such as the retailing which therefore have a large number of failures.

I would like to add to my testimony on two points. At the time we created the new index, we added a new set of data that did not previously exist. It is data on what we call business discontinuances. These are companies that close their doors and have paid all their outstanding bills. Those statistics have not leveled as failures have. In fact, there is a modest increase in the number of discontinuances. If the committee would like, I can submit a table that shows the total business closings, both the failures and the discontinuances, if you would like to have that information.

The second addition to my testimony is we have just completed a survey of the Dun's 5,000, which is 5,000 companies of all sizes, large, medium, and small. We asked those companies last month to tell us what their outlook was for employment in 1984. There are two important points. We did the same survey last year and we were quite surprised to see the buoyancy of employment outlook in January 1983, before the recovery had developed. It turns out that at that time we found that 75 percent of the projected employment growth was in firms with fewer than 500 employees. In other words, most of that employment growth was projected in smaller firms. In fact, if you look at the very large firms, those with 25,000 or more workers, they projected last year that their total employment would fundamentally remain stable.

This year, once again, we have found—and the survey results will be released in 2 weeks—the preliminary information shows that, once again, small businesses have an optimistic outlook for adding new workers in 1983, but the total addition of workers is expected to be somewhat less than was true last year. In fact, on an aggregate basis, the 4-percent gain which was achieved last year in total employment, new jobs, would, on the basis of this survey, be about a 3-percent gain. But that is a lot of new jobs. That's 2.5 million more jobs added to our economy. The firms that have fewer than 20 employees will account, according to this survey, for nearly a third of the jobs gained in 1984.

So I submit, Mr. Chairman, that our current data suggests that the outlook in very short terms has improved for small business. The behavior of what is actually going on suggests that the stress is still there because the number of failures is high. But it is not increasing as it has been for the past 3 years. I think, Mr. Chairman, that provides a good basis for some positive action.

Thank you.

[Mr. Duncan's prepared statement follows:]

PREPARED STATEMENT OF JOSEPH W. DUNCAN, CHIEF STATISTICIAN, THE DUN & BRADSTREET CORP.

THE NUMBER OF BUSINESS FAILURES IN 1983

During 1983 the number of business failures reported by the Dun & Bradstreet Corporation increased by 23.6 percent over 1982 levels; an increase to 31,334 reported failures of businesses that closed their doors, leaving behind unpaid liabilities. Using the number of businesses listed in D&B Directories as a measure of the total number of businesses, the number of failures increased to approximately 110 per 10,000 listed businesses, the highest level since 1932 when the rate was 154.

Date for the period since 1945 are shown in Table 1 on the next page.

Table 1

Historical Trend in Business Failures

Year	Number of Failures	Total Failure Liabilities	Failure Rate Per 10,000 Listed Concerns	Average Liability Per Failure
1945	809	30,225,000	4	37,361
1946	1,129	67,349,000	5	59,654
1947	3,474	204,612,000	14	58,898
1948	5,250	234,620,000	20	44,690
1949	9,246	308,109,000	34	33,323
1950	9,162	248,283,000	34	27,099
1951	8,058	259,547,000	31	32,210
1952	7,611	283,314,000	29	37,224
1953	8,862	394,153,000	33	44,477
1954	11,086	462,628,000	42	41,731
1955	10,969	449,380,000	42	40,968
1956	12,686	562,697,000	48	44,356
1957	13,739	615,293,000	52	44,784
1958	14,964	728,258,000	56	48,667
1959	14,053	692,808,000	52	49,300
1960	15,445	938,630,000	57	60,772
1961	17,075	1,090,123,000	64	63,843
1962	15,782	1,213,601,000	61	76,898
1963	14,374	1,352,593,000	56	94,100
1964	13,501	1,329,223,000	53	98,454
1965	13,514	1,321,666,000	53	97,800
1966	13,061	1,385,659,000	52	106,091
1967	12,364	1,265,227,000	49	102,332
1968	9,636	940,996,000	39	97,654
1969	9,154	1,142,113,000	37	124,767
1970	10,748	1,887,754,000	44	175,638
1971	10,326	1,916,929,000	42	185,641
1972	9,566	2,000,244,000	38	209,099
1973	9,345	2,298,606,000	36	245,972
1974	9,915	3,053,137,000	38	307,931
1975	11,432	4,380,170,000	43	383,150
1976	9,628	3,011,271,000	35	312,762
1977	7,919	3,095,317,000	28	390,872
1978	6,619	2,656,006,000	24	401,270
1979	7,564	2,667,362,000	28	352,639
1980	11,742	4,635,080,000	42	394,744
1981	16,794	6,955,180,000	61	414,147
1982	25,346	NA	89	NA
1983	31,334	NA	110	NA

This increase results from a number of factors. First, the long period of economic stagnation from 1979, resulted in a difficult economic environment for many businesses. (Gross National Product per capita in the fourth quarter of 1983 was slightly more than the level achieved in the first quarter of 1979, hence for five years the total level of U.S. economic activity was essentially flat.) Second, this economic stagnation was accompanied by very high interest rates, placing unprecedented stress on corporate balance sheets and requiring a significant portion of available cash flow in many businesses. Third, the U.S. economy is in a period of substantial restructuring with the emergence of new high-risk, high-tech businesses and the consolidation of older, more traditional businesses. This restructuring is being accelerated by increasing foreign competition and by the development of a low inflation economy which makes cost savings and efficiency a more central part of market competition.

Another factor (which is difficult to prove in statistical terms) relates to the changing social and legal view of bankruptcy. The revision of the personal bankruptcy laws made it easier for individuals to file bankruptcy and restart their financial life. At the same time some very large corporations decided that Chapter 11 reorganization was an acceptable business strategy for gaining time to overcome current problems. In combination these developments probably mean that some business owners are choosing bankruptcy today even though, in previous periods, they would have struggled to avoid the stigma of bankruptcy. In other words, since the finances of many very small businesses are closely intertwined with personal finances, business bankruptcy action is viewed as a more acceptable strategy than was true a decade ago.

Recent Data

There is some evidence that the number of business failures has reached a plateau. The date in Table 2 on the next page are based on a new index developed at The Dun & Bradstreet Corporation. The new index is a result of expanded coverage of businesses listed at our National Business Information Center. This expanded coverage creates a discontinuity with my previous testimony before this Committee on June 23, 1982. As noted in that testimony (Appendix A, page 10), I pointed out that:

> "The D&B failure analysis covers business of all sizes and of all types of legal organization, i.e., corporations, partnerships and individual proprietorships. A business does not have to be listed in the D&B file to be included provided that it is engaged in a type of business (commercial or industrial) covered by the analysis. Major areas not included in the D&B file include finance, insurance, real estate, amusement and recreation services, health services, legal services, educational services, social services, museums, membership organizations, private households and miscellaneous services.

We now include these service businesses in our tabulations of business failures. For my comments it is important to note that our revised procedures result in an improved statistical series which is not directly comparable to earlier statistics reported by Dun & Bradstreet since it now includes the areas which were previously excluded and since our new procedures provide for more rapid checking and tabulation of failure characteristics. The index which I will now review was developed to splice together the old and the new data series. While the discontinuity will create some short term difficulties in making year over year comparisons, the resulting data base will be both more comprehensive and much more timely.

Table 2

D&B Index of Business Failures

Week	5 Week Moving Average for Month	Index*
November 3, 1983		105.7
November 10, 1983		106.6
November 17, 1983		106.8
November 24, 1983	105.0	100.7
December 1, 1983		102.0
December 8, 1983		102.0
December 15, 1983		100.5
December 22, 1983		95.9
December 29, 1983	99.7	92.9
January 6, 1984		92.6
January 13, 1984		90.3
January 20, 1984		87.8
January 27, 1984	91.7	91.9
February 3, 1984		100.1
February 10, 1984		96.5

*Based on an average of the preceding five weeks with the level of October, 1983, set to 100.

This table shows that the index has been within a narrow range for the past four and one-half months. It is significant that the index level of 96.5 for the latest week for which data was available when this testimony was prepared (the week of February 10th) means that there had been little change in the level of business failures since October of 1983, the base period for the new index.

To put this development in perspective I calculsted a five week moving average index for the period from 1980 through 1983 using similar procedures for each October to February time period. In other words I created a new index base of 100 in the October of each year. For these earlier periods the index for the second week of February would be 135.4 in 1982, and 148.0 in 1983, reflecting the fact that business failures were rising sharply in both early 1982 and 1983. Thus our new index (which adjusts for changes in our coverage and procedures) demonstrates that the number of business failures are now on a plateau, compared with earlier periods of sharp increases.

This leveling off in the number of business failures reflects that fact that the U.S. economy has emerged from a period of recovery in which past levels of economic activity were finally exceeded to a period of *economic expansion*. In this improved economic environment it appears that the number of business failures has crested.

Failures by size

Our new statistical system provides more detailed information on a timely basis than was available earlier. To illustrate this we now tabulate data on the size of outstanding liabilities using more detailed categories than the over $100,000 and under $100,000 categories which have been traditionally used.

The data in Table 3 summarize the size characteristics of reported failures during the past five months (*using partial data for February 1984*).

Table 3

Business Failures by Size of Liability
(for known liabilities)

LIABILITIES:	Oct. 83	Nov. 83	Dec. 83	Jan. 84	Feb 84*
$1,000,000 And Over	6.8%	7.1%	6.4%	7.6%	8.0%
$500,000 Through $999,999	7.5%	6.9%	6.7%	7.2%	5.9%
$100,000 Through $499,999	31.8%	32.1%	34.4%	35.8%	33.7%
$50,000 Through $99,999	17.1%	17.9%	16.4%	17.8%	19.1%
$10,000 Through $49,999	25.6%	24.5%	24.1%	21.4%	22.6%
Under $10,000	11.2%	11.5%	12.0%	10.2%	10.7%

*First two weeks only.

The small shifts in the size distribution during this short period are not statistically significant. However, it is noteworthy that over one-third of the failures involve modest liabilities of $50,000 or less. If fact, one-tenth of the failures involved reported unpaid liabilities of less than $10,000. These data are not measures of the size of the business but it is reasonable to assume that many of the failures with modest levels of outstanding liabilities are indeed very small businesses.

Failures by Industry Type

A second method for classifying business failures is by type of industry, using the Standard Industrial Classification system as the basis for defining business activity. The data in Table 4 summarize the patterns for the past several months.

Table 4
Business Failures Classified by Industry

INDUSTRY:	Oct 84	Nov 83	Dec 83	Jan 84
Mining	2.2%	2.4%	2.0%	1.8%
Construction	14.5%	14.6%	15.1%	13.4%
Non-durable Manufacturing	4.1%	4.1%	3.7%	4.4%
Durable Manufacturing	6.5%	7.9%	7.7%	7.1%
Transportation and Utilities	4.5%	4.4%	4.4%	4.4%
Wholesale Trade	11.6%	11.0%	10.8%	10.1%
Retail Trade	30.5%	29.4%	30.7%	30.8%
Finance, Insurance, & Real Estate	4.3%	4.1%	4.2%	4.9%
Service	21.8%	22.1%	21.4%	23.1%

The pattern of business failure by industry sector also has been stable in recent months. The relatively large proportion of failures in retail and services reflects the fact that there are both large numbers of firms in these sectors and that many of these businesses are small. Once again, it should be emphasized that the broader coverage of the new statistics means it is not feasible to compare distributions in recent months with those reported earlier.

Business Failures by Region

The final request of the Subcommittee was to specify business failures by region. The data in Table 5 are consistent with the statistics presented above. The focus of Table 5 is the regional distribution of business failures for the major Census regions. Once again the differences appear to be stable in the short term. The changes of percentages in the past several months are not statistically significant.

Table 5

Business Failures by Region
(Percentage of total reported failures by region)

REGION:	Oct 83	Nov 83	Dec 83	Jan 84
New England	3.2%	2.9%	3.1%	2.7%
Middle Atlantic	10.6	11.0	11.1	10.8
East North Central	17.6	16.5	18.1	14.7
West North Central	5.8	4.1	5.8	5.2
South Atlantic	12.4	12.7	14.2	13.7
East South Central	5.4	6.5	4.9	5.7
West South Central	12.9	11.9	10.9	12.0
Mountain	10.4	7.8	8.7	8.7
Pacific	22.7	26.6	23.2	26.5

Conclusion

The Dun & Bradstreet Corporation closely monitors the health of business. One area of focus is a daily monitoring of the credit worthiness of businesses, large and small. Our statistics on business failures (businesses that close their doors and leave unpaid liabilities) have long been an important indicator of the health of business.

These statistics have recently been improved by incorporating greater coverage of service enterprises. The new statistics show that the level of business failures is now on a plateau, following three years of sharp increases. This reflects that fact that the business climate is now one of economic expansion offering more opportunities for firms to meet their business obligations.

DUN & BRADSTREET DATA ON BUSINESS FAILURES

Presented by Joseph W. Duncan, Chief Statistician
The Dun & Bradstreet Corporation

Presented before the Subcommittee on General Oversight

House Committee on Small Business
June 23, 1982 (This earlier hearing provided information
on the Background for today's statement).

PREVIOUS TESTIMONY

I am honored to have this opportunity to discuss with you The Dun & Bradstreet Corporation data concerning business failures. High interest rates have created heavy pressures on most businesses since they require both short-term capital to finance inventory and other working capital requirements and long-term debt to finance plant and equipment improvement and expansion. The payment of high interest costs makes it difficult for many businesses, both large and small, to operate profitably,

Before discussing current trends in our statistics I would first like to discuss the source of our information. Then, after summarizing current data I would like to comment on some of our studies about the causes of business failure.

Background

Business failure data have been published by Dun & Bradstreet since 1857. These statistics are widely reported in government publications such as the *Statistical Abstract*, the *Survey of Current Business* and the *Economic Report of the President.* Dun & Bradstreet uses a pragmatic definition of business failure in collecting our statistics. Our definition is:

> "Business failures include those businesses that ceased operations following assignment for bankruptcy; ceased with loss to creditors after such actions as execution, foreclosure for attachment; voluntarily withdrew leaving unpaid obligations; were involved in court actions such as receivership, reorganization or arrangement; or voluntarily compromised with creditors."

(Source: *The Business Failure Record, 1980;* published by The Dun & Bradstreet Corporation, page 3.)

While this definition is pragmatic it is less comprehensive than other concepts of business failure. A more inclusive concept of business failures would include firms that ceased operation with a loss to the owners, even if the creditors did not suffer a loss. Economists might argue for an even broader definition which views a business failure to occur whenever a firm earns a rate of return on investment which is less than the opportunity cost from other forms of investment. However, I would underscore the view that the pragmatic definition used by Dun & Bradstreet is useful and well accepted, even in view of these alternative concepts. This definition is particularly useful for evaluating the classical economic problems relating to business failures; the secondary effects on relatively innocent bystanders. (It should be noted that the definition of business failure in the McGraw Hill Dictionary of Modern Economics is:" The cessation of operations by a business concern because of involvement in court procedures for voluntary actions which will result in loss to its creditors." (Source: McGraw Hill Dictionary of Economics - 2nd Edition, New York, McGraw-Hill, 1973; page 66.)

Sources of Data and Method of Collection

The data published by The Dun & Bradstreet Corporation are collected by reporters employed by the Operations Division of The Dun & Bradstreet Corporation. The reporters work in branch offices located throughout the U.S. Data on court actions are obtained from daily checks of the court records; an activity which is an essential part of the credit reporting function of our business. Data on non-court actions are obtained from a variety of sources such as scanning of auction and foreclosure notices, contacts with local Boards of Trade and Credit Managers Associations, as well as from the reporters' rounds of regular interviews in the process of preparing business information reports on millions of individual businesses. (We maintain an active file on nearly 5 million businesses in the United States.)

The information is sent from each office to the Business Economics Division in New York. For each case, a questionnaire is prepared by the branch office reporter and combined with copes of notice regarding failure actions and the complete Business Information Report on the business. These reports are edited and coded by The Business Economics Division.

A preliminary weekly recapitulation is made manually using two liability size groups, five operational functions, and nine major geographic regions. This weekly report is prepared and mailed to news media and to subscribers.

At a later date (after follow-up with branch offices for omissions, inconsistencies, and revisions) a monthly computer analysis is prepared showing a breakdown by major lines of business, by state and regions, largest cities, liability size groups, Federal Reserve districts by function, as well as Duns Failure Index, adjusted and unadjusted, showing apparent annual failure rate per 10,000 listed enterprises. These reports are also made available to news media and to subscribers.

In addition, there is a quarterly report to subscribers which provides a more detailed breakdown by line of business (3 digit level in the Standard Industrial Classification - S.I.C. - and in some instances 4 digit level of the S.I.C.). Annually, a booklet is prepared which shows the historical trend in numbers, liabilities, rates per 10,000, age distribution, and a summary of causes. The 1980 is provided as an attachment to this statement.

The only size breakdown which we have available is on liability size. We do not have either number of employees or current sales volume figures on all cases since a significant proportion of the businesses which fail are not listed in the D&B information file. As for liability size, approximately 95 percent of the failures involve liabilities of less than $1 million.

Coverage of Analysis

The D&B failure analysis covers business of all sizes and of all types of legal organization, i.e., corporations, partnerships and individual proprietorships. A business does not have to be listed in the D&B file to be included provided that it is engaged in a type of business (commercial or industrial) covered by the analysis. Major areas not included in the D&B file include finance, insurance, real estate, amusement and recreation services, health services, legal services, educational services, social services, museums, membership organizations, private households and miscellaneous services.

Some of the differences between the statistics in the Dun & Bradstreet failure analysis and the bankruptcy statistics of the Administrative Office of the U.S. Courts reflect the differences in coverage which result from the exclusions described above. But, a primary reason for the differences between the two series is that the Courts count case numbers, not businesses. When a partnership files bankruptcy, each partner is assigned a case number. In the case of a large conglomerate, each subsidiary may file separately and thus be assigned separate case numbers. In earlier years, husbands and wives in proprietorships were assigned separate case numbers but now that has been corrected. Still, this change in reporting practice distorts the historical trend in the series of the Administrative Office of the U.S. Courts.

Further, the opinions of a D&B reporter and a court clerk may differ on what constitutes a business operation. In attempting to check on some bankruptcy case classified as a business, our offices have reported that local directories, banks, etc., show no evidence of such an operation having existed. In other instances, the list of creditors may indicate personal debts rather than business debts.

In earlier years, the Court count of case numbers used to specify broad functional categories. Comparison with these indicated a fairly good correlation on Manufacturing and Merchants but a big proportion of their cases were classified as "Others In Business".

Our series on the number of failures per 10,000 listed firms is based on a comparison of the number of business failures recorded in comparison with the number of firms listed in the Dun & Bradstreet Directory. As a statistician I would quickly note that there are limitations to this approach. First, as noted above not all businesses are included in our

Directory. Second, there is no universally accepted measure of business establishments. Many individuals ranging from farmers to housewives to moonlighting professionals have incorporated into proprietorships, partnerships or limited corporations. Some of these activities are not economic in the sense that they are primarily organized for tax purposes. Others are non-economic in the sense that they provide a marginal addition to family income. Still others are anticipatory of future successes in business activity.

One source of statistics on the number of proprietorships, partnerships and corporations is available from the Internal Revenue Service statistics on income. These data are summarized in Table 1 along with estimates of the number of business enterprises listed by Dun & Bradstreet.

In a review of sources of business failure data by the Congressional Research Service, the following conclusions about alternative sources is made: "Thus, it appears that for purposes of analyzing business failures, the Dun & Bradstreet data, despite their exclusion of major business segments and other limitations, are in most respects superior to the bankruptcy data of the U.S. Administrative Office of the Courts." (Source: "Business Failure: "A Review of the Concept and its Significance in the American Economy," by Julius W. Allen, Consultant and Mark Jickling, Reference Assistant, Congressional Research Service, The Library of Congress, September 16, 1981; HG 3760 U.S., Page 6).

What Do The Dun & Bradstreet Data Show

Statistics on business failure are summarized in our annual publication entitled "The Business Failure Record." I have made available copies of our latest report for 1980. Three tables summarize historic and recent trends. Table 2 summarizes the record of the post-war period.

The failure statistics have been compiled since 1857. A chart of the trend, 1857-1950, has also been provided to the staff of this committee. A chart on page 14 and 15 of the most recent Business Failure Record shows the trend 1920-1980 while page 2 of that report provides the yearly figures from 1925 through 1980.

A record high was reached during the depression of the early 1930's while lesser peaks have been registered since that date in the recession periods designated by the National Bureau of Economic Research. In 1932 the total number of failures equaled 31,822. This resulted in a failure rate per 10,000 listed concerns of 154, over 3 1/2 times the rate calculated for 1981.

The current recession has been accompanies by a sharp increase in the number of business failures. As noted earlier, our preliminary estimates are refined several months after the initial estimates become available. In fact, we are still completing work on finalizing the 1981 record. It is clear that the number of business failures increased sharply in 1981. The total number of failures increased slightly over 45 percent from the 1980 level which was 55 percent above 1979. This two year increase of 128 percent is the sharpest post war increase since the 1947-49 period when the restructuring of the economy was reflected in a high rate of business failure.

Preliminary data for 1982 show that for the first 23 weeks of this year, the number of reported business failures is 44.3 percent over one year ago.

The pattern by industry and geographic region is also summarized in Tables 3 and 4. In 1981 the greatest increase in the level of failures was in construction, with services ranked second. During the first 23 weeks of this year the wholesaling and manufacturing sector have recorded the largest increase in the level of business failure.

On a regional basis the largest number of failures occurred in the Pacific and the East North Central regions in 1980, 1981 and the first weeks of this year. Because of the high level of failures in these regions the percent change in recent weeks has not been as high for these regions: however the number of failures in these regions remains high.

Causes of Business Failure

Each year Dun & Bradstreet conducts a review to determine some of the reasons for business failures. The results are reported in the Business Record. The classification of causes combines the opinion of some of the largest creditors with the information in the D&B reporter file.

Over the years the review shows that the major reason for business failure is lack of experience. In nine out of ten failures, the lack of managerial experience or aptitude proved to be the underlying factor behind lack of business success. Surprising, this ratio holds relatively steady whether the economy is booming or is falling into a recession.

In 1979, for example, a rising proportion of entrepreneurs either had no previous experience in the line or no previous managerial experience. This was true in all types of operation but it was most noticeable among retailers -- over 19 percent ventured into unfamiliar lines and over 17 percent risked starting up new businesses without any managerial know-how.

This finding should not be interpreted as an offset to the difficulties associated with high interest rates or falling sales levels. As interest rates have remained high, receivables difficulties were cited in a growing number of cases of failure. At the present time, such difficulties are reported in the greatest proportion of cases in a decade.

Heavy operating expenses in the face of sagging sales are also a major cause of failure. While this is partly attributed to lack of management experience and ability respond to changing conditions, it also reflects the difficulties associated with a depressed economy.

During the past decade there is a general trend that the rate of business failure has declined for businesses with ten or more years of experience, following an earlier pattern over 20 years for increasing rates of failure among experienced firms. In contrast the failure rate has picked up for firms with six to ten years of experience. The rate of failure for businesses which have existed less than five years has been relatively stable. More than anything else, these trends reflect the ebb and flow of business by sector and region.

Conclusions

It is difficult to gain a truly comprehensive picture of business failure because the statistics are influenced by problems of coverage, definition, and reporting accuracy. Nevertheless, it is unquestionable that a growing number of businesses are unable to survive in a recession with high interest rates. While the levels and rates of failure at this time are not abnormal, it is clear that a prolonged recession will have a heavy toll on the business population.

Tight credit and effective cost controls are likely to dampen the business recovery as businesses remain cautious following the difficulties of two back to back recessions and continuing lackluster economic performance.

In the longer term, the present low levels of housing activity, auto sales, and consumer durables suggest that basic demand exists for a sustained business recovery. Recently enacted investment incentives also create a framework for economic recovery. However, lower costs of capital (lower interest rates) are clearly essential before the consumer or the investor makes strong positive moves.

Table 1

Estimates of Business Population, 1955 - 1978
(all numbers in thousands)

	Number of Proprietorships, Partnerships and Corporations based on U.S. Internal Revenue Statistics of Income			Estimated Number of Business Enterprises Listed by Dun&Bradstreet
	Proprietorship	Partnership	Corporations	a/
1955	8,239	NA	807	2,644
1960	9,090	941	1,141	2,702
1965	9,078	914	1,424	2,533
1970	9,400	936	1,655	2,443
1975	10,882	1,073	2,024	2,676
1976	11,358	1,096	2,082	2,759
1977	11,346	1,153	2,241	2,782
1978	12,018	1,234	NA	2,762

NA = Not available

a/ Dun & Bradstreet publishes both the number of business failures and the rate of failure per 10,000 listed enterprises. The business population estimates in this column are derived by dividing the number of business failures by the failure rate.

Data from: Internal Revenue Service and The Dun & Bradstreet Corporation.

Source: This table is reproduced from Congressional Research Service Report No. 81-195 E, Business Failure: A Review of the Concept and Its Significance in the American Economy, by Julius W. Allen with the assistance of Mark Jickling, September 16, 1981, HG 3760 U.S., page 5.

Table 2

Historical Trend in Business Failures

[This Table is updated as Table 1 in the Testimony.]

Table 3

Preliminary Report of Failure Trends Year 1981 vs. 1980
(Failures by Size, Function and Region)

	1981	1980	Per Cent Change
U.S. Total	17,044	11,742	+45.2
Liabilities			
$100,000 & over	8,516	6,060	+40.5
under $100,000	8,528	5,682	+50.1
Function			
Manufacturing	2,249	1,599	+40.7
Wholesaling	1,738	1,284	+35.4
Retailing	6,981	4,910	+42.2
Construction	3,674	2,355	+56.0
Services	2,402	1,594	+50.7
Region			
New England	547	464	+17.9
Middle Atlantic	2,381	1,580	+50.7
East North Central	2,770	2,091	+32.5
West North Central	1,313	883	+48.7
South Atlantic	1,783	1,127	+58.2
East South Central	1,149	841	+36.6
West South Central	1,670	1,378	+21.2
Mountain	649	416	+56.0
Pacific	4,782	2,962	+61.4

Source: Weekly Failure Report, Business Economics Division, Dun & Bradstreet

Mr. MITCHELL. Thank you very much.

Under what kind of time constraints is your schedule?

Mr. DUNCAN. I have realined part of my schedule, so I can stay with you about half an hour.

Mr. MITCHELL. Would you gentlemen mind if we just got in one or two questions to him now?

Mr. BRADFORD. Go right ahead, Mr. Chairman.

Mr. MITCHELL. I would suggest that we limit ourselves to just one question. My question is very brief.

Is there a place where we, as members of the committee, can find what the total failure rate for small businesses is? Not all small businesses report to Dun & Bradstreet, and I suspect the Department of Commerce doesn't have this data. Is there any central location where we could find this?

Mr. DUNCAN. Mr. Chairman, as far as I know, the only source of business failure data that is comprehensive is the Dun & Bradstreet data base. There is, of course, data through the U.S courts on the number of filings for bankruptcy, but that doesn't have the firm or industry characteristics that we have.

Let me explain our data base just very briefly, one level. We have about 6 million businesses listed in our files. If you look at IRS data about total corporations, there are between 10 and 12 million businesses. So that seems like we don't cover everybody. But if you look at the total employment in the economy that is represented in our file, it is 97 percent. In other words, the IRS data on business corporations, which includes proprietorships and various forms of incorporation, a large number of those are tax shelters, noneconomic activities. Therefore, the numbers are somewhat inflated.

It is true that no one knows exactly how many businesses there are. But I would submit, Mr. Chairman, that the profile of business in our 6 million is very representative of the total profile of business in the country.

Mr. MITCHELL. I have limited myself to just one question.

Congressman Smith?

Mr. NEAL SMITH. Well, I'll follow along on the same thing.

Is 6 million the number today or the number in 1981? The way you look at it, how many were there in 1981 and how many today?

Mr. DUNCAN. Our file literally changes daily. Our 6 million number is our current number of businesses listed in our files at the National Business Information Center, for which we have financial information about companies——

Mr. NEAL SMITH. That you call small businesses?

Mr. DUNCAN. No, the total companies in our file.

Mr. NEAL SMITH. How many do you call small businesses?

Mr. DUNCAN. Once again, small business is a question of definition, on employment size or asset size. You tell me what definition you would like to apply for small business and I can——

Mr. NEAL SMITH. I thought maybe you had a definition that you used.

Mr. DUNCAN. I tend to focus on very small employment size companies, that is, those with 50 or fewer workers and 20 or fewer workers. I do have some data on that, if you would give me a minute to find it.

We take the data on size of employment as a percent of total. For example, in my sample that we just drew, 25 percent of those companies are fewer than 20 employees and 18 percent are fewer than 100 employees. That is the characteristic of our file overall.

Mr. NEAL SMITH. I think it's the same question, but let's get the answer to one question here. Using that definition, how many are there today and how many were there in 1981?

Mr. DUNCAN. The actual total level has changed very modestly, because there are many companies that discontinue—as I say, they go out of business. So our file tends to have, in a given year, net additions of only a couple hundred thousand; whereas, in fact, there are 400,000 new starts coming into the file.

Mr. MITCHELL. Congressman Daub.

Mr. DAUB. As I read your testimony, I was most impressed, on page 12 particularly, with the thorough treatment of the way in which businesses do fail, 9 out of 10 of them, of course, because they have no experience, or a lack of experience, and it is not necessarily that interest rates and falling sales and curtailed consumer capability to buy don't have a major impact, but, in fact, the actual reason why they failed.

Another thing that I noticed from your testimony, but I don't see it detailed too much, is the fact that in 1930 in the Great Depression the forms in which we did business are not even comparable to the forms in which we do business today. So that if one were to index and compare today's rate of business failure with the rate of business failure in 1930, we would be talking about apples and oranges. So I think the index is useful, but you just took my question away by indicating that some 400,000 businesses start compared to the numbers that fail, and I hope that you continue to publish those figures as well in this changing economy. Beyond that, we appreciate your being here.

Mr. DUNCAN. Thank you, Mr. Congressman.

Let me just comment about the data in here on the rate of business failures. There is a consistency with the 1930 numbers in this sense: We use as a denominator for that index the firms that are listed in Dun & Bradstreet directories, and so the failures in the 1930's were related to the base of the kinds of companies that could be included in our directories in that period. So they were comparable as to enumerator and denominator.

If you go back before the 1930's, it was interesting to me that in the 1920's, which you and I probably view as a dynamic period, it turned out to also be a high risk taking period. The number of business failures per 10,000 listed firms was over 100 every year in the 1920's.

Mr. MITCHELL. Congressman Hayes, do you have a question?

Mr. HAYES. Being heedful, Mr. Chairman, to the principles of seniority, I yield my 1 minute to you.

Mr. MITCHELL. I want to thank you very much, but I won't take it right now.

Congressman Molinari.

Mr. MOLINARI. In keeping with the spirit of the chairman, I will ask no questions.

Mr. MITCHELL. Thank you. We took a long time with that first panel and we thank you for being patient in waiting with us. Whenever you're ready to leave, please do so.

I thank both of our next witnesses for being so patient, one of whom I have known for many years, Mr. Travers Bell, and for whom I have an enormous respect. I believe you were the first black firm on the stock market?

Mr. BELL. The New York Stock Exchange.

Mr. MITCHELL. On the New York Stock Exchange. And now there are two?

Mr. BELL. Well, there were. Now there's still one.

Mr. MITCHELL. Back to one. OK.

Gentlemen, if you will give us your testimony, we would appreciate it, whoever wants to go first. Mr. Bell.

TESTIMONY OF TRAVERS J. BELL, JR., CHAIRMAN OF THE BOARD, DANIELS & BELL, INC.

Mr. BELL. Mr. Chairman and distinguished members of the Small Business Committee, I will give a synopsis of the testimony that I am submitting for the record.

Mr. MITCHELL. Without objection, your entire statement will appear in the record.

Mr. BELL. Thank you, Mr. Chairman.

The Department of Commerce has researched and found that after a 38-percent growth rate in the manufacturing sector for minority entrepreneurs from 1972 through 1977, the rate of growth for minorities was virtually flat from 1978 to 1982. Further, they found that the manufacturing sector was the target area where minority firms should concentrate their efforts of entry to effect the largest impact on employment, marketing opportunities, and exports. High interest rates prevented those goals from being pursued or realized.

Forces in the economy, such as continued tight monetary policy by the Federal Reserve Board, the multi-hundred-billion-dollar deficits, along with an improving economy which demands new credit, will keep the interest rates high throughout the balance of the 1980's and little prospect is held for it being significantly reduced in the early 1990's without major policy changes. These factors are virtually agreed upon between the House Budget Committee, the Federal Reserve Board, the administration's chief economist, and the private sector.

High interest rates negative impact on small and minority businesses experienced during the last 4 years can be fully expected to persist for the next several years. It is my opinion that the negative impact will be gradually aggravated as the economy as a whole positions itself to survive and prepare for a new business environment. The new business environment is being thrust upon the American scene as American corporate managers find difficulty in identifying new markets and products in the world economy. Mergers and acquisitions are thrusting their way into corporate America as the only prospect for growth our corporate managers can rely on.

This phenomenon is pressuring the banking systems demand for credit, as evidenced by the recent $10 billion required by Texaco to purchase Getty Oil. This virtually forces small and minority businesses out of the credit markets and most certainly puts upward pressure on interest rates.

Persistent high rates must focus our attention to investor equity. The three areas of equity to be viewed for small and minority business are venture capital, pension funds, and the public market. Many venture capital opportunities do still exist, and the Nation and minorities must give resources and responsibility to a dealmaker, a venture capitalist, to pursue minority economic development. Venture capital current resources are estimated at approximately $200 billion in equity, and minorities account for one-tenth of 1 percent, or $200 million. Incentives to establish a substantial venture capital fund can come from assorted private and Government sources without budget line items. Programs can be implemented within a 1-year period. It should be noted that our ideas include funding successful MESBIC's to continue encouraging small minority businesses.

Pension funds are the largest pool of private capital in the United States, at approximately $1 trillion and growing at the rate of 20 percent per year. Currently, pension funds own over one-third of American business through their stock and bond purchases. By 1985, they will own 50 percent, and it is estimated by the end of the century they will own two-thirds of America's corporate structure.

Minorities have no control over any portion of this private capital, even though it is estimated that over $100 billion has been directly contributed by and for minorities retirement benefits. The Nation's pension funds are handled by only a handful of investment managers and New York Stock Exchange firms. Statistics estimate that 90 percent of this pool of capital is managed by only 100 firms, or an average of $10 billion per organization. It is then no surprise that the majority of economic power is controlled by a few, with small and minorities businesses conspicuously absent.

Public equity is certainly a viable resource for many small minority businesses. There are thousands of public companies in America and our research shows only four are now minority companies.

Sophistication is a good description for today's complex securities market apparatus. There are many new minority employees in majority investment firms, and additionally, majority firms handle investments from minority groups. Electronics video has made financial information and education available to all.

There are literally hundreds of new financings each year offered to the public market for startup businesses. The reason minorities are excluded is the absence of quality deals available to them. Investment bankers don't show minority entrepreneurs good deals because minorities are not in the good deal pipeline.

Congress could make good deals flow to minority entrepreneurs through minority member firms of the New York Stock Exchange by providing incentives to major corporations to channel divestitures through minority investment firms. This is a matter which could be accomplished without taxpayer dollars.

The Congress of the United States must address itself to providing incentives to existing capital sources to encourage investments through approved competitive minority equity vendors. Investor incentives on capital have already helped to accelerate corporate development and to create jobs. Even the Federal Government's own studies show that the increased investment will greatly expand job opportunities in the years ahead.

It is clear that favorable investor incentives encourage new investments. It is also clear that even with favorable investment incentives, minority businesses do not benefit on an equal basis. Therefore, minority investments must be more attractive to compete against traditional investment vehicles.

From a GAO study, we conclude investor incentives for each $500 million in private capital invested in minority firms, should annually earn the U.S. Government 150 new and better financed minority businesses, $15 billion in new sales, 300,000 new jobs, $250 million in new corporate income tax, $700 million in employee tax revenue, and $2 billion in export sales.

The hard reality is that creating a large number of jobs will require large amounts of additional investment, and much of it must come from individual investors. Enhanced investor incentives for individual capital will greatly improve the prospects of securing the investment needed for minority business expansion and the creation of jobs.

So ends the synopsis of my report, Mr. Chairman.

[Mr. Bell's prepared statement with attachments follows:]

PREPARED STATEMENT OF TRAVERS J. BELL, JR., CHAIRMAN OF THE BOARD, DANIELS & BELL, INC.

The past few years of high interest rates have caused the collapse of hundreds of small and minority businesses whose profit margins were traditionally under ten percent (10%). This group of high leveraged businesses simply could not withstand the loss of its profit margins to increased interest cost and the prospect of financing the reduced cash flow with more bank debt.

This unique interest equation was further compounded by the tight monetary policy of the Federal Reserve Board which penalized banks who were frequent borrowers at the discount window. Banks who were receiving requests for additional loans to finance cash flow requirements of all businesses, particularly small and minority enterprises, were discouraged from providing more financing to companies with thin profit margins. Many small and minority business managers recognizing the double negative impact of existing debts and the need for financing cash flow, chose to close their businesses, liquidate or obtain protection from its creditors under the law.

High interest rates which toppled thin marginal businesses also detoured the wave of "leveraged buyouts".

This financing technique being used by small and minority businesses in recent years was encouraged by major banks and insurance companies who had established urban loan centers to facilitate the purchase of existing operating businesses. The interest rate environment eliminated the "leverage buyouts" and brought to a halt the coming of new and more substantial minority businesses. Many of the companies purchased with this technique suffered severe setbacks as increased debt servicing eliminated most equity capital. The reduction in equity capital triggered the need for new capital from existing equity partners or new sources which reduced minority equity and sometimes control of the new business enterprise.

In addition to "thin margin" businesses, others like manufacturing were also severely strained during this high interest rate period. Unlike service businesses, an industry where labor can be associated very directly with revenue, the cost of inventory requirements and capital equipment was virtually prohibitive in manufacturing.

This had a terrible impact on minority businesses which the Department of Commerce has researched and found that after a 38% growth rate in the manufacturing sector from 1972 through 1977, the rate of growth for minorities was flat from 1978 to 1982. Further, they found that the manufacturing sector was the target area where minority firms should concentrate their efforts of entry to effect the largest impact on employment, marketing opportunities and exports. High interest rates prevented those goals from being pursued or realized.

Since minority business persons have traditionally relied on debt to enter and maintain business development, equity capital throughout this period has had little or no effect on business trends.

Forces in the economy such as continued tight monetary policy by the Federal Reserve Board, the multi hundred billion dollar deficits, along with an improving economy which demands new credit, will keep the interest rates high throughout the balance of the 1980's and little prospect is held for it being significantly reduced in the early 1990's. These factors are virtually agreed upon between the House Budget Committee, the Federal Reserve Board, the administration's chief economist and the private sector.

The incident of negative impact on small and minority businesses experienced during the last four years can be fully expected to persist for the next 6 to 8 years. It is my opinion that the negative impact will be gradually aggravated as the economy as a whole positions itself to survive and prepare for a new business environment. The new business environment is being thrust upon the American scene as American corporate managers find difficulty in identifying new markets and products in the world economy. Mergers and acquisitions are thrusting their way into corporate America as the only prospect for growth our corporate managers can rely on.

This phenomenon is pressuring the banking systems demand for credit as evidenced by the 10 billion dollars required by Texaco to purchase Getty Oil. This virtually forces small and minority businesses out of the credit markets and most certainly puts upward pressure on interest rates.

Most research has focused on the ability of small and minority businesses to attract equity capital as the single most important issue we face over the next 10 years. I agree with this priority. I must also observe that new equity must have the ability to attract existing businesses which are in recession resistant industries.

The three areas of capital to be viewed are Venture Capital, Pension Funds and Public Equity.

Venture Capital is America's most glamorous and professional method of financing new businesses. Andrew Mellon and David Rockefeller are among our nation's fathers of Venture Capital. The impact of these men on venture capital investments has created such new businesses as: RCA, Burroughs Corp., International Business Machines, McDonnell Douglas Aircraft, Alcoa Aluminum, Mellon National Bank, Chase Manhattan Bank and many, many other such notable establishments. America's Venture Capital tycoons are fathers of today's new technology. It should be crystal clear that Venture Capital does not have to be directed through numerous organizations; only a few are required, if not just one or two. A person of financing skills, analytical capacity, balance sheet savy, a deal maker and closer and one tough son of a bitch are what make true Venture Capitalists.

These few examples of new companies created by the Venture Capitalist mentioned would have had a substantial impact on the minority economy if only these few companies were minority controlled.

These particular companies are now out of the Venture Capital category but new opportunities do still exist, and the nation and minorities must give resources and responsibility to a deal maker, a Venture Capitalist, to pursue minority economic development. This is a most difficult point to grasp. The nation and its minorities fear one or two people having such power, but why, when it's the only way development has ever been accomplished in history.

Venture Capital resources are another stumbling block. Current resources are estimated at approximately 200 billion dollars in equity and minorities account for one tenth of one percent or 200 million dollars. Incentives to establish a substantial Venture Capital fund can come from assorted private and government sources without budget line items. Programs can be implemented within a one year period. It should be noted that our ideas include funding successful MESBICS to continue encouraging small minority businesses.

Venture Capital is a real working tool for economic development and minorities cannot afford to ignore this in their efforts.

Pension Funds are the largest pool of private capital in the United States at approximately one trillion dollars and growing at the rate of 20% per year. Currently pension funds own over one third of American business through their stock and bond purchases. By 1985 they will own 50%, and it's estimated that by the end of the century they will own two thirds of America's corporate structure. Minorities have no control over any portion of this private capital even though it is estimated that over 100 billion has been directly contributed by and for minorities retirement benefits. Not only is there no control over any portion of these pension funds by minorities, but neither are the existing managers investing any of these funds in or through minority enterprises. See enclosure 2, Department of Commerce statement. Some have thought that regulations may have prevented minority participation but the Department of Labor who administers the Employee Retirement Investment Securities Act, has made it clear that no regulation prohibits minority participation, leaving minority exclusion to what the Department of Commerce terms "Racism and Tradition". See enclosure 3, Department of Labor. The nation's pension funds are managed by only a handful of investment managers and New York Stock Exchange firms. Statistics estimate 90% of this pool of capital is managed by only 100 firms, or an average of 10 billion dollars per organization. It then is no surprise that the majority of economic power is controlled by a few with minorities conspicuously absent.

A percentage of managed pension capital should go to minority investment managers. This would be a reasonable and significant start for minority economic development. Accompanying legislation should encourage pension funds to invest up to 5% of managed funds in and through minority enterprises.

Minorities must have access to pension funds.

Public Equity is a viable resource for many minority businesses. There are thousands of public companies in America and our research shows only 3 are minority companies.

Many say that the securities market is sophisticated and thus minorities are excluded because they are not familiar with this sophisticated financial engine. Still others say that the securities market concentrates on "matured" businesses and minority businesses are not in or approaching this category.

Sophistication is a good description for today's complex securities market apparatus, but minorities do have the intellect and understanding for these markets. There are many new minority employees in majority investment firms to confirm this point; additionally majority firms handle investments from minority groups. Electronics video has made financial information and education available to all and it would indeed be a racist view to deprive minority participation because someone deems them less sophisticated.

As for "matured" business, there are literally hundreds of new financings each year offered to the public market for "start up" businesses. The reason minorities are excluded is the absence of quality deals available to them. Investment bankers don't show minority entrepreneurs good deals because minorities are not in the good deal "pipeline". I don't believe this exclusion is caused by racism; it is caused by tradition, but it is exclusion just the same.

Congress could make "good deals" flow to minority entrepreneurs through minority members of the New York Stock Exchange by providing incentives to major corporations to channel divestitures through minority investment firms. This is a matter which could be accomplished without much effort and without taxpayers dollars. A good deal flow and access to the previously mentioned capital sources is essential and would change the structure of minority business enterprises in America, allowing them the opportunity to complete freely and on an equal footing with other firms.

The Congress of the United States must address itself to providing incentives to existing capital sources to encourage investment through approved competitive minority equity vendors.

Investor incentives on capital have already helped to accelerate corporate development and to create jobs; most importantly, a larger and larger equity base is being built for the future. The flight into tangible investments has subsided and confidence in productive financial investments has been greatly restored. After a lengthy depression, equity values have recovered and moved to new high ground. The increased demand for equities and resulting higher equity prices are enabling more and more young and rapidly growing companies to do common stock financing.

Even the Federal government's own studies show that all this increased investment will greatly expand job opportunities in the years ahead.

Experience has proved without any reservation, that incentives have bolstered capital investment and produce offsetting job creating new equity. Minority enterprise investments must be more attractive to equity capital investment to compete with traditional vendor sources.

It is clear that favorable investor incentives encourage new investments. It is also clear that even with favorable incentives, minority businesses do not benefit on an equal incentives basis. Therefore, minority investment must be more attractive to compete against traditional investment vehicles.

In August 1982, the U.S. General Accounting Office issued a comprehensive study of the venture capital industry. Most importantly, the GAO study gives some specific illustrations and projections of what venture capital investments mean to job creation. By utilizing proprietary data of Venture Economics Division, Capital Publishing Corporation, the GAO was able to trace the development of 1,332 companies that received venture capital backing in the last decade. An even more detailed analyses were made of 72 companies that "went public", made possible because more information was available on them.

"The experiences of 1332 companies that were started with venture backing during the 1970's demonstrate benefits to the nation's economy and productivity that are disproportionately large when compared with the amounts of capital invested. For example, with $209 million invested to create 72 of these firms, their combined sales in 1979 alone totalled $6 billion. (1) Growth in annual sales averaged 33 percent a year end, in the process, these firms created an estimated 130,000 jobs, (2) over $100 million in corporate tax revenues, (3) $350 million in employee tax revenues, and (4) $900 million in export sales.

The GAO study goes on to project what the total sample—1332 companies in which $1.4 billion in venture capital was invested in 1970-1979—could produce in 1989.

Potential benefits from 1332 venture backed companies in 1989

[In billions of dollars]

Sales	88.8
Corporate income taxes	1.7
Employment (million)	1.9
Employee taxes	5.0
Export sales	13.6

In the sample of 72 companies, the investment of an average of $1,608 of venture capital led to the creation of one job. In the longer range projection, covering 1,332 firms, an average initial investment of $739 is needed for one job. Neither figure represents all the capital required to create a job. Virtually all the firms involved will need other forms of outside financing as they develop—public offerings of stock or bonds, bank loans, etc. and their capital is augmented by retained earnings. But is it clear that the type of seed money provided by venture capitalists has immense leverage on job creation.

We conclude investor incentives for each $500 million in private capital invested in minority firms should annually earn the U.S. government 150 new and better financed minority firms, $15 billion dollars in new sales, 300,000 new jobs, $250 million in new corporate income tax, $700 million in employee tax revenue, and $2 billion in export sales.

The hard reality is that creating large numbers of new jobs will require large amounts of additional investment and much of it must come from individual investors. Enhanced investor incentives for individual capital will greatly improve the prospects of securing the investment needed for minority business expansion and the creation of jobs.

ENCLOSURE 1.—TRAVERS H. J. BELL, JR., NEW YORK, N.Y.

Experience:

1971-Present.—Daniels & Bell, Inc., Member of The New York Stock Exchange, Inc. Chairman of the Board.

1967-1971.—Fusz Schmelzle & Co., Inc., Member of The New York Stock Exchange, Inc. Vice President and Director.

Diversified Data Systems—Computer Service Bureau (Subsidiary of Fusz Schmelzle & Co., Inc.) President and Director.

1961-1967.—Dempsey Tegler & Co., Inc., Member of The New Stock Exchange, Inc. Vice President.

Education:

Washington University, St. Louis, Missouri. New York Institute of Finance, New York, New York.

Organizations:

Official, American Stock Exchange, Governor, Securities Industry Association (SIA); Advisor, Institute for Economic Research, Advisor, Institute for Economic Research; Advisor, U.S. Secretary of Commerce: Committee on Minority Enterprise Development; Trade Advisor, The International Cocoa Agreement, Geneva, Switzerland; Trade Advisor, United States Trade Representative (USTR), Commodity Policy (CPAC).

Member, Legislation Committee of the SIA; Registered Floor Broker, Commodity Futures Trading Commission; Member, District Committee No. 12 of the National Association of Securities Dealers (NASD); Director, SIA Minority Capital Foundation; Member, Council on Foreign Relations, Inc.; Financial Consultant, Economic Community of West African States Fund for Cooperation, Compensation and Development.

Member, U.S. Small Business Administration Task Force on Equity and Venture Capital; Member, The New York Stock Exchange; Member, The New York Stock Exchange Hearing Committee; Advisor, North Atlantic Treaty Organization (NATO), the Common Market, and the Supreme Headquarters Allied Power of Europe (SHAPE), Brussels, Belgium; and Advisor, NATO Southern Flank Military and Economic Review and Appraisal for Governments of Italy, Greece and Turkey.

ENCLOSURE 2.—REPORT TO THE SECRETARY FROM THE ADVISORY COMMITTEE ON MINORITY ENTERPRISE DEVELOPMENT

3.0.5. PUBLIC LAW 95-507

On the surface it appears that PL 95-507 has been effective in gaining increased minority participation in Federal procurements. However, we know of no information that addresses the question of how this program is impacting the stability, and long-term growth of minority enterprise. Questions such as what happens to minority firms once they are ineligible for 8(a) contracts, and what are the difficulties which non 8(a) minority firms face in doing business with the Federal government have not yet been addressed.

3.0.6. ERISA—MINORITY-OWNED BROKERAGE HOUSES

Over $600 billion in pension fund transactions are processed each year by brokerage firms belonging to New York Stock Exchange. Although there are minority brokerage houses who are members of the New York Stock Exchange, all have been excluded to the best of our knowledge. The committee feels that appropriate Department of the Treasury and Department of Labor officials who have the responsibility for administering ERISA should take appropriate actions to insure that pension fund principals and trustees develop procedures which will motivate investment manager to develop procedures which would allow minority firms who are members of the New York Stock Exchange to participate in the execution of pension fund transactions on a competitive basis. At this juncture we are not certain whether the problem lies in existing regulations and legislation governing these transactions or in exclusionary practices founded in racism or tradition. The Committee will present its analysis and recommendations on this matter at a future date.

ENCLOSURE 3.

U.S. DEPARTMENT OF LABOR,
Washington, D.C., December 31, 1980.

Hon. PARREN J. MITCHELL,
U.S. House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN MITCHELL: This letter responds to your inquiry on behalf of Mr. Travers J. Bell, Jr., which was forwarded to us by Mr. Walter C. Terry of the Office of Small and Disadvantaged Business Utilization for comment. Mr. Bell is concerned that the activities of minority member firms of the New York Stock Exchange relating to the execution of securities transactions for corporate pension funds may be impaired by the fiduciary responsibility provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

The Department does not believe that the provisions contained in ERISA impede the ability of pension fund managers to utilize the services of unrelated minority member firms for the execution of securities transactions. Specifically, section

408(b)(2) of the ERISA permits pension plans to secure necessary services under reasonable contracts or arrangements so long as not more than reasonable compensation is paid for the services. The Department has previously indicated its position that brokerage services are clearly the type of service contemplated by section 408(b)(2) of ERISA. Accordingly, pension fund managers may utilize minority member firms to execute securities transactions on behalf of plans provided the conditions of section 408(b)(2) are met.

The Department further notes that section 402(c)(3) of ERISA permits a fiduciary named in the plan instrument to appoint one or more investment managers to manage plan assets. In many instances, the fund manager will be delegated the responsibility for determining which brokerage firm will execute securities transactions on behalf of the particular pension plan. There is, however, no provision in ERISA which would prohibit a plan sponsor from issuing guidelines consistent with the prudence rule of section 404(a) of ERISA regarding the direction of brokerage transactions to minority firms. Thus, plan sponsors may encourage their fund managers to utilize the services of a minority member firm of the New York Stock Exchange for the execution of transactions in pension fund portfolios on a competitive rate basis.

I hope this information will be of assistance to you.

Sincerely,

June E. Patron,
Assistant Administrator,
Pension and Welfare Benefit Programs.

Mr. Mitchell. Thank you very much. I jotted down some questions which I will put to you.

Mr. Bradford.

TESTIMONY OF WILLIAM D. BRADFORD, PROFESSOR OF FINANCE, UNIVERSITY OF MARYLAND, AND VISITING PROFESSOR OF FINANCE AND ECONOMICS, YALE UNIVERSITY

Mr. Bradford. Good afternoon, Mr. Chairman. I am William Bradford, Professor of Finance at the University of Maryland, and visiting Professor of Finance at Yale University. It is with great pleasure that I appear before the committee to share some of my recent experience and research concerning minority businesses.

Now, U.S. Government policy concerning minority-owned business is correctly concerned with the rate of formation, growth and failure of these businesses. The current status of minority businesses overall can be measured by analysis of business participation rates, or the analysis of the proportion of all businesses and business receipts owned by minorities. With regard to participation rates, the latest Survey of Minority Business concludes that there were 13.9 minority businesses per thousand minority persons, compared to 63 nonminority businesses per thousand non-minority persons.

If we talk about the proportion of receipts and number with respect to minority businesses, minority businesses represent 4.8 percent of the number and earn 0.6 percent of the receipts of all U.S. businesses. That minority businesses are small is also evident from census statistics which show that only 207 minority businesses have over 100 employees, and recent unpublished U.S. Department of Commerce data also conclude that less than 20 minority businesses have over 500 employees.

Now let me talk about failure rates. Exhibit 1 in my paper shows that the failure rate these are Commerce data which they have developed which looks at the failure rate of minority businesses compared to a controlled group of nonminority businesses, matched via age, size and industry.

The exhibit shows that the failure rate of minority firms relative to nonminority firms is 60 percent greater. These data relate to the first part of 1983, which is the latest available date.

In addition, when we look at these data from 1977 on up to the start of 1983, the minority business failure rate has been increasing relative to the nonminority rate since November 1980.

In this regard, minority business firms are typically more susceptible than nonminority firms to failure during the first stages of a general economic recovery, which to some extent we are in now. This is because the economic condition of minority communities remains stagnant or depressed and the recovery in such communities typically lags that of the overall economy. Thus, the increasingly higher failure rate for the minority firms is expected to exist until the U.S. economy is further into the recovery.

Now, I want to talk about borrowing costs. The economic environment of minority and small businesses can also be examined by reviewing the levels and changes in the rate of interest paid by small businesses on loans from commercial banks since 1977.

Commercial banks, which provide 30 to 40 percent of all liabilities of the small business sector, are the major external financing sources of funds for small business. In addition, small businesses tend to obtain a higher proportion of their total funds from debt. These two factors compound the importance of bank financing to small and minority businesses; thus, a change in bank credit availability can greatly affect the financial condition of small and minority businesses.

With respect to the cost of financing, exhibit 2 provides data on the nominal and real interest rates charged by commercial banks for loans to small businesses. The exhibit shows that the cost of bank borrowing has been high in recent years, and the real borrowing rate—that is, the nominal rate of borrowing less the rate of inflation as measured by the GNP deflator—that rate, in 1983, was over twice as high as the average real borrowing rate in 1977-80. Thus, in recent years, the cost of obtaining debt has been relatively high, and then, on top of that, the recession that we're coming out of—which, of course, impacts the minority economy to a greater extent than the general economy—given that, the economic outlook for minority businesses has been and remains poor.

In addition to the cost of credit, we can also examine credit availability. I look at credit availability for minority businesses in two ways. First, the total funds provided to small businesses can be compared to funds provided to the Federal Government using flow-of-funds accounts. Exhibit 3 shows that the total debt funds supplied to nonfarm, noncorporation businesses—which is a good proxy for small businesses—in 1977 was $28.3 billion; whereas in 1982, which is not shown on that exhibit, but near the end of 1982, the latest data available, the level was $25.9 billion. This reflects that because of the high cost of funds, and the reduction of bank lending to small businesses, the total amount of funds made available to the small business sector has declined.

Another related way to review the financing of minority business is to examine the volume of SBA loan guarantees provided to all small and minority businesses. Exhibit 4 shows that SBA guaranteed loans to all small businesses and to minority businesses have declined in both current and constant dollars since 1979. From 1979 through 1983, the real dollar value of loan guarantees to minority-owned businesses—that is, using the GNP deflator—declined from $151.2 billion to $102.3 billion, or 32.3 percent.

Total SBA loan guarantees in current dollars declined from $2.7 billion to $2.4 billion in 1983. Thus, the debt financing of small and minority businesses has been hampered by both high interest rates and a reduction in credit availability.

Mr. Chairman, I would like to amend that number concerning the $151.2 billion to $102.3 billion. Those numbers, in terms of the magnitude, should be in millions. However, the same conclusion would hold. In other words, it was $151.2 million. The point is, when I looked at the raw data, the level in terms of both current and constant dollars has declined.

In addition, of course, the SBA direct loans,which are a major source of debt financing for minority businesses, has declined in both current and constant dollars; from $89.8 million in 1979 to $20.1 million in 1983.

My last comments are that the success of small businesses is dependent upon their access to equity capital and to credit from financial institutions for debt capital. That is, when we look at how businesses grow, there are five stages in the typical life cycle of a business—research and development being the first, then start-up being the second, early growth being the third, accelerated growth being the fourth, and maturity being the fifth.

The capital needs of a business differ depending upon which phase the business is in. The first three stages are characterized by little or no profits and/or the cash flows are negative. During these stages, personal wealth, or the wealth of friends, should be the basic source of financing in the form of primarily equity capital. However, as one would anticipate, the significantly lower wealth levels of minority groups dictates that, on average, less seed capital is available from personal or family assets to support the first three stages of business development.

Evidence supporting the seed capital hypothesis emerges from the surveys of minority businesses, which shows that the greatest growth in minority firms has occurred in industries that require low startup capital, such as retail trade and services. This trend, if it continues as it has, will lead to a minority business sector which is skewed toward lower growth industries and weaker firms, which will not be able to contribute significant wealth increments to society.

I have some recommendations which I will briefly state.

No. 1, the SBA loan guarantees have had a $500,000 limit in size since 1976. Besides the real value of this amount declining since 1976, the variability, I believe, of business capital needs has increased in the minority sector. It is recommended that the limit on the size of the loan guarantee be lifted and made somewhat more flexible in amount. That is, some industries require substantial financing as working capital and long-term capital, and $500,000 does not appear to be sufficient. SBA should be able to grant the assistance to meet the more flexible need that exists. Industry maximums, or percentages of starting equity or private capital up to some broader maximum appear to be more desirable.

Second, in order to increase the desirability of investing in SBA loans from the lender's perspective, a secondary market for such loans is desirable: It provides liquidity and the ability to turn funds over into additional SBA loans.

Now, I know that a program to assist secondary market activities in SBA loans is underway. However, the program has some problems in terms of supporting a good volume. I believe some additional effort should be had in that particular area.

Third, the Federal funding of the Minority Development Agency has remained flat in current dollars over the last 5 years, which means that the real value of the effort has declined. This is in the face of higher interest rates, growing minority business failures, and lingering recessionary conditions in the minority community. These conditions should bring more efforts at promoting minority enterprise, instead of less. Current plans are to reduce the funding for enterprise development at the MBDA. This is a time in which the efforts in this area should be increased.

My fourth recommendation relates to MESBIC. Basically, a study with respect to why these organizations have not invested to the extent that they can is needed. I see that concept of equity capital and venture capital for the minority sector as being crucial to the development of a strong minority business sector, but for some reason these organizations—and I have looked at them before—have not developed to the extent that we think that they can. So I think that those areas need to be reviewed.

Last, the lack of knowledge of the economic and financial status of minority businesses is an impediment to making good policy decisions. I recommend that the surveys of minority business be undertaken every 3 years instead of every 5 years, and that the lag time of information output be reduced from 3 years to 2 years. For example, the 1982 survey will be out in 1985, and the information made available will not likely provide the then current status of the group studied.

This concludes my remarks before the committee. Thank you.

I would like to submit for the record the following exhibits which help to substantiate and corroborate my comments.

[The information referred to above follows:]

EXHIBIT 1.—BUSINESS FAILURES PER 10,000 FIRMS

	Minority firm failures per 10,000 firms	Nonminority firm failures per 10,000 firms	Minority/ nonminority
April 1980 to September 1980	480	360	1.33
October 1980 to March 1981	500	526	0.95
April 1981 to September 1981	700	692	1.01
October 1981 to March 1982	1,100	858	1.28
April 1982 to September 1982	1,500	1,024	1.46
October 1982 to March 1983	1,900	1,190	1.60

Source: Minority Business Development Administration, U.S. Department of Commerce. Failures include firms which discontinue operations, not just those that cease operations, with unpaid liabilities.

The figures were smoothed to remove suspected reporting lags.

The control group of nonminority firms is matched to the minority group for size, age and industry.

EXHIBIT 2.—INTEREST RATES ON SHORT-TERM BANK LOANS TO SMALL BUSINESSES

[Annual average 1977–83]

	Nominal	Real
1977	8.7	2.6
1978	10.3	1.8
1979	13.0	4.9
1980	15.9	5.7
1981	20.0	11.1
1982	17.3	12.7
1983	13.7	9.7

Source: Federal Reserve Board. The rates are for loans of $25,000–$49,000. Real rates are the nominal rates less inflation as measured by the GNP deflator.

EXHIBIT 3.—TOTAL CREDIT BORROWING 1971–82

[In billions of dollars]

	1971	1973	1975	1977	1979	1980	1981
Federal Government	24.9	8.3	85.4	56.8	37.4	79.2	87.4
Nonfarm noncorporate	11.6	29.8	12.5	28.3	34.4	33.8	40.5
Percent of total credit borrowed	18.2	4.4	44.2	17.9	9.6	22.3	22.3
Percent of total credit borrowed	8.5	15.9	6.5	8.9	8.8	9.5	10.4

Source: Federal Reserve Board, Flow of Funds Accounts.

EXHIBIT 4.—GUARANTEED LOANS—SMALL BUSINESS ADMINISTRATION

	1979	1980	1981	1982	1983	1984 (auth.)	1984 (reg.)
Minority:							
Number	2,709	2,859	2,587	1,426	1,905		
Thousands of dollars	247.1	260.7	267.1	154.6	220.5		
Total:							
Number	23,948	24,934	23,215	12,247	17,198		
Thousands of dollars	2,648.8	3,027.7	2,900.7	1,531.6	2,426.1	3,280.0	3,280.0
Total: thousands of dollars	151.2	145.9	136.6	74.7	102.3		
Constant 1972 dollars							

Source: U.S. Small Business Administration.

Mr. MITCHELL. I thank both of you gentlemen for very exciting and very interesting testimony.

Mr. Bell, there are two problem areas for me. You and I have often discussed the potential use of pension funds as some form of venture capital or investment in minority business. You run into the situation in which people who have pension funds obviously want to guard them very carefully, and I understand that.

Couple that with the idea that, in general, the impression is that minority businesses are more risk-taking businesses than others, would that not suggest that we would need something above and beyond just the normal investment of these funds, some kind of additional incentive for the pension funds to invest?

Mr. BELL. Mr. Chairman, I think perhaps you are right in terms of providing incentives. But I think, also, in the text of the presentation I presented today, that I think, being a member of the securities industry, we are as concerned as others with the competitive return for investment of all pensioners retirement benefits. I think it is somewhat confusing to say that minority firms can't provide competitive type of returns within a competitive environment.

Mr. MITCHELL. Excuse me. Let me clarify what I'm saying. I am talking about a perception of minority businesses versus the reality.

Mr. BELL. The perception is certainly there. I was just trying to illustrate, for instance, the United States Steel merger and the LTV merger, National Steel, Getty versus Texaco, Bendix, and that sort of thing. There are just literally hundreds of well-financed and organized companies that take to their investment bankers and sell to other organizations. I am saying there are substantial opportunities out there. Although the perception is they can't belong to minorities, I'm not terribly sure why.

I do think that incentives certainly would be helpful in that particular area, tax incentives to sell divestitures to minority entrepreneurs using pension funds, because most of these are secured by the assets of the organizations being purchased.

Mr. MITCHELL. What kinds of incentives for other than pension funds are there? The reason I raise that question, I have been hanging around this place for a long period of time and we have done things in the past to try to get various business entities, venture capital people and others, interested in investing in minority firms through an incentive program. But, quite frankly, these have not succeeded. I don't know why, but they simply have not. Maybe you could give us some recommendations as to some kinds of incentives which might succeed.

Mr. BELL. One that comes to my mind pretty quickly, Mr. Chairman, is to provide investor incentives to the larger amount of corporate and individual shareholders in America to invest in minority-owned businesses. Those kinds of funds simply do not get invested in minority-owned businesses.

The sort of incentives that work in the securities industry is the same sort of incentives that will work in the minority investment community. I often sometimes wonder, Mr. Chairman, why people try to devise a separate set of parameters for minority businesses as toward other businesses in general.

Specifically, one of the things that comes to mind is the deferment of capital gains if they would be reinvested in minority-owned firms. I think that would generate a significant amount of new capital into minority-owned firms. That, in itself, I think would be quite innovative.

In addition, it is a way that the investment community understands. I think once we get into that process of doing the things that they understand, that we can get into the pipeline of creating more venture capital dollars and having more, if you will, better deals shown because of the broader support.

Mr. MITCHELL. Dr. Bradford, one of your charts which deal with bank financing, making reference to that, we have already heard testimony that there appears to be a differential in terms of financing between large corporations and small businesses in general.

In your study, is there a differential between minority small businesses and nonminority small businesses, in terms of bank financing?

Mr. **Bradford**. Mr. Chairman, I am in the process of gathering those data now. I am not prepared to present results to you, but I will present those later on the record, if you so desire.

Mr. **Mitchell**. I would be most interested in seeing that. You hear lots of rumors, and I don't think we have had a secure, objective, analytical study done in that area.

The other question that I had, obviously you have indicated that the failure rate for minority businesses is great and you pointed out several reasons why. It just seems to me that, in addition to that, your testimony suggests that because of a number of circumstances—lack of access to capital and so forth—more and more minorities are being crowded into the retail area. In Mr. Duncan's testimony, that is the area that is experiencing still the highest rate of bankruptcies.

Does that not suggest a rather grim picture for the next couple of years? If that's the area we're being forced into, and that's the area that is still the most vulnerable according to Mr. Duncan, does that not suggest even a greater increase in failures in minority businesses?

Mr. **Bradford**. Chairman Mitchell, I believe that that is going to be the case. That's why I feel now is the time to do some significant actions toward assisting minority businesses, because this is a readjustment in our overall economy, of course, including the business sector, the small business sector, and the minority business sector. Things that are done currently and in the near future are going to be impacting minority business for a relatively long time, for the intermediate to long-term period.

Mr. **Mitchell**. To both of you gentlemen, I have about six more questions. Is it all right if I submit them to you in writing?

Mr. **Bradford**. Yes, sir.

Mr. **Bell**. Yes, sir.

Mr. **Mitchell**. I would appreciate it. I thank you very much for taking the time to be with us.

We now come to our last group which consists of Bernard Browning, who is chairman of the board, National Small Business Association, and president of General Business Services in Rockville, Md.; Junius Dumas, of J. L. Dumas & Co., and Andrea Mack, legislative counsel for the National Association of Minority Contractors; Charles Gilbert, president of Gilbert Machine Tool Co.; and David Smith, vice president and treasurer of the National Association of Home Builders and also the owner of David Smith and Sons.

You have been most patient with us, and we are deeply appreciative. Obviously the committee had a lot to learn and we have to ask questions. I thank you for taking the time to be with us.

Mr. Browning, if you would lead off for us, please.

TESTIMONY OF BERNARD S. BROWNING, CHAIRMAN, BOARD OF TRUSTEES, NATIONAL SMALL BUSINESS ASSOCIATION; ACCOMPANIED BY HERBERT LIEBENSON, PRESIDENT, NSBA

Mr. **Browning**. Thank you, Mr. Chairman.

You have my prepared statement and, with your kind permission, I will not repeat that but take the few minutes allotted to me to supplement and highlight some of the items in the statement.

Mr. MITCHELL. Without objection, for all of the panelists, if you have a prepared statement before us, those statements will be submitted in their entirety for the record.

Mr. BROWNING. I am sure the chairman is aware that the National Small Business Association has been representing small businesses here since 1937. What many people may not be aware of is that in 1977 we were instrumental in establishing the Small Business Legislative Council in conjunction with some 80 other trade associations so that when we speak as a group we are talking on behalf of 5 million small businesses.

I am here today in my volunteer role as chairman of the National Small Business Association, but in my earn-a-living role, I am president of General Business Services of Rockville, which is a small business consulting organization. We have about a thousand franchise business counselors throughout the country, and I tallied up the other day that since I started this company in 1962 we have had the privilege of counseling and working with some 150,000 different businesses. So I give you that information to reassure you that we feel we have a pretty good handle on what is happening in small business in America.

I think if all 15 million businesses—and my colleague, Joe Duncan, dismisses all except 6 million in their data bank—could be here this morning at this committee hearing, they would all applaud the fact that the inflation rate in the last few years has gone down from 12 percent to 4 or 5, that we have had a drop in interest rates from 21 percent to 11 or 12. This along with the reduced taxes, which are not as reduced as much as they should be, has started the economy growing somewhat.

I can tell you that in traveling around the country and in talking with all kinds of small businesses, every one is scared about the big deficits. Small business is the job creator in America. I think that has been documented by every study involved with it. But I can tell you that we are scared that that those deficits are going to eventually come down on us and we're going to pay a high price. Like many things of which we're not sure, we are apprehensive as to just how it's going to happen to us, but we sort of feel like it's a sword over our head.

We want those deficits reduced. I have yet to talk to a small businessman who did not feel strongly in this regard, and they do not want it reduced by raising taxes. They want it reduced by less Government spending, and if you ask, I'll give you some thoughts on that.

Entrepreneurs, in starting small businesses—and I also remind my colleagues with larger businesses that every large business was once a small business; even Henry Ford and Thomas Watson first began Ford motor and IBM as small businesses. The entrepreneurs in this country have created the wealth. They have not just divided it up. They have created the wealth that has made the standard of living possible that we have today. I submit to you, Mr. Chairman, and your distinguished committee, and all the other Members of Congress, that entrepreneurs and small business can do much, much more if they are given a chance. When I say given a chance, as one of the panelists just preceding here mentioned about incentives, entrepreneurs work to make a profit in return for taking risk, and working long hours and working hard. So those incentives are well known, if they will just merely be provided.

In my prepared statement we discuss bankruptcies, and again Joe Duncan went into that in detail and I do not fault any of his statistics. I merely want to reiterate the point that he mentioned—and you asked, Mr. Chairman, for some information about the total closings. This is very, very significant. In my statement also we point out the formal bankruptcy statistics, but what I wanted to supplement was that the best information that we can come up with is for every formal bankruptcy which is recorded, there are four to five closings that just fade away. As a business consultant, it is embarrassing for me to sit here and tell you, but I'll just take 2 minutes and share one.

Two friends of mine a few years ago suggested—we had a colleague who had retired. He had reached that point in life where he didn't want to quit, but he couldn't get a job in his seventies and he wanted to open a small business. We decided to bankroll him and help him. He struggled with it. He closed that business, paid every debt except those of us who had invested to start him. We're the losers. There are many, many of those that pay off their obligations but the owners or the stockholders lose. We think there are at least four to five, and there may be more. But I was delighted with your question and I hope that either someone in the Government or Dun & Bradstreet can pursue that.

I can also tell you that, while discussing bankruptcies, there is no business owner that I'm aware of who wants to pay taxes so that the Government will support some other business that's inefficient. This is something that we see somehow being brought up occasionally. There should be an opportunity for success, but it must be matched with the opportunity to fail because that's the only way you cleanse the system. Otherwise, you're going to have situations where the inefficient—and the consumer pays for it in the long run. The Government role should provide the climate so as to make those odds favorable for success, and that primarily is through a tax climate, an incentive where they can make some profits.

In my statement also I offer some solutions. I call it creative financing. The first one there that I would like to emphasize beyond all the rest of them is the jobs retraining tax credit. I would submit to you, Mr. Chairman, that if we could mobilize those 15 million people—The reason between the 15 million figure that I'm using and Joe Duncan's 6 million is that there are about 6 million self-employed individuals, it may be an interior designer, a plumber, an electrician, a well digger, a farmer, all kinds of individuals who play a very significant role. It is that one-person entrepreneur who will grow and make jobs and create wealth for the people.

But I would submit to you that the jobs tax credit that we had for a 2-year period was not given sufficient opportunity to perform as it should have, and even then it made a great contribution. We all hear about how a rising tide raises all ships. If we will mobilize all of the businesses with a job retaining tax credit, we can pull down unemployment. I think on the first panel one of the witnesses provided the same statistic that I have put in my notes, that for each one million unemployed, it costs the government about $30 billion. I think that has been fairly well documented.

The value of this jobs retaining tax credit, there are also some benefits that you cannot quantify in dollars and cents. I would like to address those for just a moment, because if you have a one- or two-person business and employ an individual, the tutoring, provided is invaluable. Now, I sure that many of our educator friends would say that you need a Ph.D. and all this. But I would suggest to you that you could take a plumber, an auto mechanic, a farmer, or anyone else, and if he has someone working with him, he will be able to provide skills, knowledge, attitude, work ethic, getting to work on time, giving a day's work.

I worked my way through college at 20 cents an hour and I'm proud of it. So many people have the idea that somehow the world or the Government, which means some other taxpayer, digs into his pocket to give it to the Government, who then takes part of it and gives it back to someone else. There are so many fallout benefits from this jobs tax credit that I can't emphasize too strongly how important I think this should be in your thinking.

Because with 15 million businesses, if they would each put on one, we could wipe out the unemployment. We could probably take care of the deficit in the process. But even more important is that if—and I realize I'm talking theoretically—but if you had 15 million people coaching one other person, particularly the individual who is unskilled, the person that may be a school dropout but may be a terrific auto mechanic. My favorite auto repairman at the moment is a fellow who had a one-man business. As an auto mechanic, he took a youngster who wasn't very good scholastically, dropped out of school. Over the last 3 to 4 years he has developed that youngster into a top flight mechanic. He is running a job retraining program without the benefit of Uncle Sam providing any incentives. How sad. Here's a fellow struggling hard, but he should be given a little break because that youngster is learning more from that person toward his attitude toward work, toward life, than he will ever get in any kind of massive governmental program where you institutionalize people and put 400 or 500 people in a park somewhere.

The second item on that page 13 has been addressed very nicely by the earlier panel, about borrowing from pension funds. I will not dwell on that because I think he did it very well.

The third item there is something that is done in Europe that we have not done, and that is to permit banks to have equity in small businesses. I would also feel that with the small business venture capital firms this is something that should perhaps be encouraged even more than the bank equity, but both are avenues that should be pursued.

The next item is one that I would also like to give second priority to the jobs tax credit, and that is the small business participating debentures. I think that this again is talking about entrepreneurs, permit profit, provide incentives. The small businessman, as I mentioned in the earlier part of my prepared statement, gets started in business by, one, saving his own money—and he may have to sacrifice to do that; secondly, he will borrow from his family or get relatives to invest, and then he will go to his friends. There are many businesses that can get started on a small investment—it doesn't take $1 million—and it is on character. This is why many small town banks make loans on character that a big city bank would turn down. So that small business participating debentures is a vehicle by which I think we can mobilize the entrepreneurial spirit in America and get all those entrepreneurs to tap their friends and their relatives and their doctor, their dentist, and maybe even their Congressman, to make an investment——

Mr. DAUB. Now you've gone too far.

[Laughter.]

Mr. BROWNING. But I think this is a vehicle by which we can mobilize and get that entrepreneurial spirit going and moving it along.

With that, Mr. Chairman, I thank you for the privilege of being here and I will look forward to your questions.

[Mr. Browning's prepared statement with attachments follow:]

PREPARED STATEMENT OF BERNARD S. BROWNING, CHAIRMAN, BOARD OF TRUSTEES, NATIONAL SMALL BUSINESS ASSOCIATION

Good morning Mr. Chairman and distinguished members of the Committee. My name is Bernard S. Browning. I am Chairman of the Board of Trustees of the National Small Business Association (NSB) and with me today is Herbert Liebenson, President of the National Small Business Association.

The National Small Business Association is a private membership organization of about 50,000 enterprises in all lines of industry and in all parts of the country. We appreciate this opportunity to express our views on the impact of high real interest rates and their potential effect on the economy and small business.

I am the President of General Business Services, Inc. headquartered in Rockville, Maryland. General Business Services, Inc. provides financial management services to small businesses. Founded in 1962, the company now has approximately 1,000 franchised business counselors nationwide. They provide business counseling, record-keeping systems, computer services, tax return preparation and tax research to tens of thousands of small businesses.

Interest rates continue to be the most important factor in capital formation for small and medium sized businesses. Small firms are chronically undercapitalized. Virtually all their capital must come from (a) borrowing, (b) after-tax profits, or (c) additional equity investment from a restricted group familiar with the firm. In contrast, large corporations have many options of raising capital from the public by issuing additional stock, bonds, notes, or commercial paper. The level of interest rates has a decisive impact on all three small business options.

Our nation now faces the prospect of the largest deficit relative to GNP, except for the years we were at war. Economists seem to agree on the harm large deficits have on our economy and also the effects of the deficits on the long-range growth of the economy.

For the past three years we have seen that budget deficits do not make inflation inevitable. The rate of inflation has been reduced, monetary policy has been disinflationary while we have large and rising deficits. Although the precise effects of deficits in the $200 billion range are complicated, the consensus of private economists is that they spell big trouble for the economy and especially small business.

Five separate economic surveys concur that while the economy should continue growing through 1984, the prospects for a marked slowdown as early as 1985 appear very real.

These surveys recently conducted by the following organizations: the National Association of Business Economists, the National Association of Realtors, Irving Trust, the Conference Board, and the U.S. Chamber of Commerce underscore widespread confidence in trouble-free economic performance through the end of 1984. However, the first four surveys warned that rapidly rising interest rates and consumer prices could begin dampening the recovery some time soon after November's elections if nothing substantive is done this year to reduce the budget deficits.

The most probable and prudent assumption is that budget deficits crowd out private investments, not dollar for dollar, but by a very large proportion of the deficit.

The deficit adds to debt—the projection is for a staggering increase of almost $1 trillion between now and 1989. That, in turn, tends to increase the interest burden, which is part of the budget, and that annual additional burden can make it increasingly difficult to stabilize the deficit as a fraction of GNP. Also, large deficits tend to keep the value of the dollar high relative to other currencies—perhaps 20-30% higher than it should be.[1] This hurts U.S. companies that wish to export, and especially smaller companies seeking new export markets.

DIFFERENTIAL EFFECT OF INTEREST RATES ON SMALL BUSINESS

Although we are not economists, small businesses are qualified observers of economic affairs because their survival depends upon the ability to read these trends.

High interest rates do not affect all credit users equally. We have long known that smaller businesses are in the weakest position to assert their demands for credit. As Henry Kaufman, the economist for Salomon Brothers, Inc. recently concluded: "The other two key demanders—the federal government and (big) business—will always win."[2]

It is apparent that the larger and stronger the borrower, the more options in raising funds, and the lower their interest costs. Options such as commercial paper and bonds (which are often sold in minimum denominations of $25 million) and equity securities (which cannot be marketed unless a firm has annual net profits in the neighborhood of $1 million) are simply not available to the overwhelming majority of small businesses. There are only about 12,000 companies whose stock is nationally traded (on exchanges and over-the-counter) out of 15 million U.S. businesses.

In the simplest terms, the interest rate structure is a product of the supply and demand for credit.

A large government deficit is a determining factor in this structure because it is quickly translated into a large demand for credit, which, as we have seen, must always be accommodated at whatever interest rate is necessary.

Our 1981 testimony called attention to the fact that the projected deficit of $42 billion for that year would absorb about 46 percent of the available credit. Now, economists are predicting that deficits in the range of 4-6% of GNP will absorb more than half of all private sector savings.[3]

The projections of the Congressional Budget Office for fiscal years 1984-1989 show deficits ranging between 5.1% and 6.1% of GNP on a current services basis (if no changes to current law) and an alternate set of assumptions—based on low growth that range between 5.5% in 1984 and 8.2% in 1989. (See Exhibit D)

One leading columnist, regarded the results of the high interest rates since 1979 and the recessions of 1980 and 1981 as a "Massacre on Main Street".[4] If smaller business is hit with another round of high interest rates and another recession in the next year or two—you may see the small business community literally decimated—a mortality rate of 1 out of 10—as we have already seen in such areas as automobile dealerships.

One voice from Wall Street described Treasury's cash needs as "awesome" when they were raising $80-$85 billions in 1982.[5]

Another highly respected Wall Street economist, Alan Greenspan, predicted in 1981 that the expections of large deficits would put upward pressure on interest rates:

> It is not the supply in the short run of Government securities which is keeping interest rates high. It is the expectation that deficits are $120, $150, or $200 billion in the later part of the 1980s that is causing the problems today. The fiscal 1982 numbers are relevant only to the extent, in my judgment, that they affect people's perceptions in the finanical markets about the latter half of the 1980's.[6]

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[1] "Reagan Says Dollar Is Not Overvalued" Washington Post, February 23, 1984, page D4:1. Council of Economic Adviser's Chairman Feldstein estimated the dollar was over valued by 32% and would account for about half of next year's estimated $110 billion trade deficit. Ibid.

[2] "The reasons are clear-cut. The cash needs of the U.S. Government are never restrained by interest rates. Business corporations also have access to a wide range of financing alternatives, often financing long-term projects through short-term borrowings. In addition, they at least try to pass along interest payments to their price structure."

[3] Testimony of Prof. Benjamin M. Friedman before the Senate Committee on Finance, December 12, 1983, page 8.

[4] "Massacre on Main Street", by George Will, Washington Post, September 20, 1981, page C8:1.

[5] "Catch 22 in the American Economy and Credit Markets", address to the Financial Executives Institute by Henry Kaufman, Managing Director, Salomon Brothers, Inc., October 12, 1981, page 5.

[6] Testimony of hearings before the Senate Small Business Committee on "Interest Rates and Business Credit Needs," September 23, 1981, transcript page 139.

In October of 1981 we said there was a need for a "mid-course correction" that could be designed to bring interest rates down faster and further, and to keep them down in the out years. We now believe that present policy is on an unsustainable course.

COST OF CREDIT HIGH ABOVE 1970'S LEVELS

The salient feature of credit markets for the past four and one-half years is that interest rates are at the highest levels since the Civil War.

Short-term rates, as represented by the "prime rate" peaked at 21½ percent in 1980, and at 20½ percent in 1981.

Even the interest rates have come down. A summary of their comparison to traditional levels follows:

HIGH CURRENT INTEREST RATES

[Yearly average 1984 compared to 1976]

	1984	1976
3-month Treasury bills	8.63	4.989
3-year Treasury notes	10.45	6.770
10-year Treasury bonds	11.10	7.61
High grade municipal bonds (Standard & Poor's Index)	9.47	6.49
Corporate Aaa bonds (Moody's)	12.04	8.43
Prime 6-month Commercial paper	8.89	5.35
Federal Reserve discount rate	8.50	5.50
Prime rate	10.79	6.81
New home mortgages	12.57	8.99

Source: "Economic Indicators," Joint Economic Committee.

IMPACT OF HIGH INTEREST RATES ON SMALL BUSINESS

It has long been our contention that the prime commercial loan rate is about two points above the three-month Treasury bill rate, and that smaller businesses conventionally borrow at two to four points above the prime rate. Also when the rates come down, they come down further for the large businesses. This year NSB documented these facts that the spread between small and large loans has ranged over four or more points since 1982. (See Exhibit A.)

As a result, business bankruptcies have increased dramatically: for 1983 they ran at a rate of more than 162 percent above 1980.

The federal government has also experienced higher-than-expected interest costs which have exerted a destabilizing influence on the budget.

BORROWING COSTS AND BANKRUPTCIES

If the deficit forces interest rates up in the future, it could be disasterous for the small business community. As you are aware, two years ago NSB published a pioneering study on the rise in business bankruptcies and the effect of high interest rates on these business failures ("Report on Business Bankruptcies", National Small Business Association, Washington, D.C., September 21, 1981.) (See Exhibit B.)

In 1981, we were concerned that business bankruptcies increased by 40% over 1980. We are now looking at bankruptcy numbers for 1983 which were nearly triple in the 1980 total. According to recent statistics compiled by Dun and Bradstreet, business failures for 1983 were 31,334, just 500 below the figure at the depths of the Great Depression. (See Exhibit C.) For comparable periods in previous years, the figures are as follows:

[In percent]

	Failures	Increase over 1980
1983	31,334	166.85
1982	25,346	115.85
1981	16,794	43.02

	Failures	Increase over 1980
1980	11,742	
1932	31,822	

Source: Dun and Bradstreet.

Since more than 97 percent of businesses in the U.S. are small businesses, it would follow that the overwhelming majority of these statistics represent small business failures.

The number of filings for business bankruptcies compiled by the U.S. Bankruptcy Court, show a similar trend, with the 1979–1980 fiscal year used as a base:

1983	69,769
1982	92,202
1981	66,411
1980	60,084
1979	33,315

Our report addressed the question of how increased borrowing costs contributes to these bankruptcy statistics. We found about a 74–75% correlation, which economists agree is a "direct and significant correlation," between the level of interest rates and the level of business bankruptcies.[7] (See Exhibit B.)

DOUBLE DISADVANTAGE OF HIGH INTEREST COSTS TO SMALLER BUSINESSES

The annual report on "The State of Small Business" has confirmed such a differential in small business borrowing costs. (A Report of the President, March 1983, p. 231.)

These figures recall the House Banking, Finance and Urban Affairs Committee's excellent report on the "False Prime". From such studies, we are getting a clearer picture of some of the financial advantages of large size in a competitive economy. Moreover, these averages tend to blur the cases at the edges, which would show even larger gaps.

The implications of these differentials are aggravated by the effective tax rates of the borrowers. According to a recent column in the National Journal magazine, one of the consequences is a "two-tiered credit system". The analysis is as follows: "For a taxpayer in the 35 percent bracket, the deductibility of interest means that a 13 percent mortgage has an after-tax-cost of 8.45 percent. If inflation averages 5 percent during the mortgage that implies a real interest rate of 3.45 percent . . . Likewise a 7 percent interest rate would mean that the real, after-tax cost of a 12 percent bond (at the top corporate tax rate of 45 percent) would be negative. . ."

The system thus places smaller firms at a double disadvantage. As the National Journal observes: "Real interest rates will vary depending on individuals' firms' brackets. Those in low tax brackets—the lower middle and working classes plus small and weak businesses—suffer much higher real interest rates." "How High is High?", by Robert J. Samuelson, National Journal, September 17, 1983, page 1904.)

We believe that this double burden imposed by high interest rates on smaller business is likely to significantly undermine the competitive position of smaller and medium-sized firms in this country. That, in turn, will, in our opinion, fuel more and larger mergers and increasing concentration in the U.S. economy. This trend is already evident, and will, we feel, be particularly pronounced if interest rates surge again during the remainder of this decade under the impact of mega-deficits.

The current statistics are against the background of a sharply falling rate of inflation, and a multiplicity of community financial institutions to which small businesses have convenient and personal access.

We believe that the Federal Reserve System should be applauded for its courageous stand against inflation over the past four years. However, this good news may not last for very long in the face of protracted $200 billion national deficits.

Also, the tremor of consolidations that have run through the financial services industry threatens to become an earthquake in years to come.

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[7] The "following quotation is from page 4 of that report: ". . . In technical terms, the correlation between real interest rates, e.g., the nominal rate minus the inflation rate [GNP deflator] was 74.5 percent during the 3-year period covered by the chart and 73.47 percent for the 5 years from 1976 to 1981. Economists say that 74 percent constitutes a 'direct and significant correlation' between these two factors."

A 1983 study based upon interviews with the chief executive officers of banks of all sizes, bank chief operations officers, investment bankers, financial analysts, regulators and legislators, and CEOs of non-bank financial institutions produced the conclusion that the number of banks in the U.S. would decrease dramatically from 15,000 in 1980 to about 9,600 in 1990. Small banks (under $100 million in assets) expected to suffer a precipitous 41 percent decline from more than 13,000 to 7,800 in the next decade.

A related conclusion of the study was that bank assets would shift significantly toward larger banks, which would increase their percentage of industry assets from 53 percent to 65 percent, while the small bank share declined from 21 percent to 12 percent, and the medium-sized bank share declined from 26 percent to 23 percent. ("New Dimensions in Banking: Managing the Strategic Position," Arthur Andersen & Co./Bank Administration Institute, 1983.)

Of course, the full consequences of this consolidation movement can not be predicted at this time. However, certain small business financial advisors have begun to discern some undesirable changes that could have a fundamental impact on the viability of small enterprise.

The American Institute of Certified Public Accountants, in a statement to the Senate Small Business Committee in early 1983, concluded that, "The recent trend toward consolidation within the banking industry (has) had a visibly detrimental effect on small business, and if allowed to continue unabated, this trend may reach crisis proportions."

This national organization, with over 34,000 firms, cited three adverse factors from bank consolidations which were reducing the availability of loans to smaller businesses:

(1) Bank funds were leaving local communities.

(2) Bank personnel were rotated more often, disrupting existing personal relationships.

(3) Lending decisions are increasingly based on documentary evidence, rather than personal knowledge of a customer's integrity and reputation. (See Exhibit E)

We therefore believe that the structure of small business financing is also under pressure and that this Committee should be deeply concerned, as our Association is, over how changing bank structure will affect the ability of smaller firms to survive and to compete.

A particular characteristic of small business is that most are undercapitalized to begin with. Because of this, owners are often required to put up personal assets such as their homes as additional security for business loans. If a bankruptcy follows, an owner can also have his family life shattered, exacting a "toll of personal tragedy".[8]

We wish to reemphasize to this Committee that many well-managed, hitherto sound businesses were at the end of their rope during this period and were not able to continue.

DISPROPORTIONATE IMPACT OF PRESENT POLICIES ON SMALL BUSINESS

Both the Administration and the Federal Reserve acknowledge that the combination of present policies cause small businesses to bear the greatest burden.

Former Council of Economic Advisers' Chairman Murray Weidenbaum told the Wall Street Journal: "In periods of monetary restraint, the smaller, weaker borrowers suffer most".[9]

Federal Reserve Chairman Paul Volcker described the uneven effect of current policies before a Congressional committee in the following terms:

"High interest rates undeniably place a heavy burden on housing, the auto industry, small business, and other sectors especially dependent upon credit. The thrift industry, in particular, has come under heavy stress as its costs of funds exceed returns on fixed rate assets acquired when interest rates were much lower."[10]

The evidence is accumulating that small business is being asked to pay too high a price—in many cases its very survival.

According to a variety of governmental estimates, an additional million persons out of work for a year depletes the Treasury (and therefore increases the deficit) by $19-$29 billion.

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[8] Interviews with bankruptcy attorneys Samuel Greenbaum, Esq. and Charles A. Doctor, Esq., Washington, D.C., September-October, 1981.

[9] "Surge in Interest Rates Puts Squeeze on Already Ailing Economic Sectors", by Tom Herman and Edward P. Foldessy; May 7, 1981, Wall Street Journal, first page of second section, page 29.

[10] "Monetary Policy for 1981", Sixth Report of the House Committee on Banking, Finance and Urban Affairs, July 31, 1981, page 3.

Nobel Prize winner, Professor James Tobin, Economist of Yale University, stated that: ". . . the Administration's reliance on the Federal Reserve to curb inflation can hold down the economy for half the decade with capital formation discouraged either by high real interest rates or by gloomy profit calculations or both."

Representation

It also seems unfair to us that appointments to the Federal Reserve Board consistently come from the banking and large industrialist corporate sectors with little or no representation from small businesses, which accounts for almost 60 percent of the non-government workforce, 90% of the new jobs and half of all industrial innovation. Our Association supports Congressional initiatives for the appointment to the Federal Reserve Board of persons with small business experience and representation of small business—as a major segment of the U.S. economy—in the upper echelons of the Executive Branch by means of small business representation on the two key economic Cabinet Councils: Economic Affairs, and Trade & Commerce.

Data

Once access is obtained, we believe the information contributed by small business spokesmen should be of the highest quality. NSB therefore favors improved small business financial data as a basis for decisions, and a strengthened advocacy function to develop and present this information.

To this end, NSB has been working with a number of leading economists and organizations to develop a series of small business indicators which can reflect the financial status and needs of small firms on a continuing basis as a basis for balanced policy decisions.

General Economic Policy

It is the opinion of NSB that narrowing the projected deficits is imperative. Because the projections show a widening structural gap between outlays and revenues, we recognize that the longer we wait, the more difficult this process will be.

We believe that our economic and political systems are not built to operate under mega-deficits and sustained high interest costs, and small business would be the worst victim of the scenario set out by the 1985 budget.

We therefore call upon Congress and the Administration to agree this year on a strategy for bringing down the deficits over a reasonable period of time. We believe the small business community will support whatever responsible measures are necessary to do this.

As we have seen, credit crunches resulting from high interest rates do not restrict the public sector.

High rates are not inhibiting our greatest corporations from purchasing other corporations.

We have seen that larger companies have many options for raising necessary funds that smaller firms do not—commercial paper, Euro-loans, multiple lines of credit, assets to borrow against, and established internal cash flow.

Large deficits and high interest rates mean that small business bears the brunt of economic readjustment.

Creative Financing

Our Association believes small business can contribute a great deal to a sustained recovery, greater job creation (which reduces the deficit) and higher export potential. However, we need some fresh approaches to tiding over small business in this credit crunch.

In this context, we have attempted to put together several possible creative financing methods which we have been advocating investigation by the Administration and the Congress.

These include:

A broadened job retraining tax credit. This would be modelled after the successful 1977-78 credit which was used by over 1 million businesses.

Allowing small firms to borrow from pension funds, with adequate security, and perhaps to obtain financing from such funds under the leasing provisions of the new tax laws, as proposed in our application to the Department of Labor on February 22, 19[illegible].

Exploring equity banking for small enterprise, such as private financial institutions now in use in some European countries.

Establishment of a Small Business Participating Debenture, to expand the use of subordinated debt for small business as recommended by the House Democratic Caucus by name, and by the LaFalce Subcommittee in principle.[11]

In pursuing the specific recommendations such as: (1) Enactment of the Small Business Participating Debenture, (2) Two-tier Capital Gain Tax, with the rate falling to 10% after a 5-year holding period and (3) extension of the graduated corporate tax rates to 500,000. Pursuing the capital formation possibilities spelled out in the Securities Act Amendments of 1980.

Establishing small business representation on key policymaking bodies.

These methods would cost the government little or no money. They would operate by removing barriers to the investments of capital in small or other business, which is in tune with the Administration's philosophy.

SUMMARY

We feel that small business is the prime victim of the high rates of interest. Reducing the deficits and the cost of capital are the critical needs of American small business.

Continuing on a path of $200 billion or higher deficits would be taking extreme and irresponsible risks with our economy and its vital small business segment.

On behalf of American small business, the National Small Business Association, and myself, I would like to thank you all for the opportunity to express our views.

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[11] See "Blue Print," National House Democratic Caucus, January 1984, page 29; Committee Print, House Banking Committee, 98-8, November 1983, pages 37-38.

Interest Rates Relative to the Prime Rate by Size of Loan, 1980-83

WEIGHTED AVERAGE BANK LENDING RATES FOR SHORT-TERM COMMERCIAL AND INDUSTRIAL LOANS,

AUGUST 1980 - FEBRUARY 1983

ALL BANKS

Loan Size ($1,000)	8-80	11-80	2-81	5-81	8-81	11-81	2-82	5-82	8-82	11-82	2-83
1-24	13.66	15.97	19.59	19.45	20.76	20.2	18.4	18.9	17.9	14.8	14.44
25-50	13.53	15.72	19.53	19.87	21.18	19.8	18.1	18.6	17.4	14.3	13.57
51-99	13.00	16.39	19.77	19.10	21.36	19.6	17.9	18.3	17.2	13.9	13.40
100-499	12.49	15.52	20.18	19.93	21.37	19.1	17.6	17.9	16.6	13.2	12.71
500-999	12.01	15.87	20.87	19.58	21.85	18.5	17.4	17.7	15.7	12.9	11.59
Over 1 Million	10.92	15.68	19.83	20.14	21.06	16.6	17.0	16.9	12.5	10.7	9.81
Prime Rate:				19.5	20.5	17.5	16.5	16.5	15.0	12.0	11.0

SMALL BANKS

Loan Size	8-80	11-80	2-81	5-81	8-81	11-81	2-82	5-82	8-82	11-82	2-83
1-24	13.71	15.91	19.38	19.34	20.59	19.9	18.3	18.5	17.9	15.7	14.50
25-50	13.62	15.60	19.19	19.71	20.96	19.1	17.8	18.6	17.2	15.4	13.65
51-99	13.07	16.37	19.51	18.81	21.12	19.7	18.2	18.0	17.3	13.8	13.54
100-499	12.56	15.29	19.88	19.79	21.05	19.2	17.7	17.7	16.9	14.0	12.86
500-999	12.11	15.75	20.94	19.28	21.96	18.8	17.3	18.1	16.1	13.0	11.52
Over 1 Million	11.38	15.54	20.27	19.45	21.21	17.9	16.8	17.0	13.8	11.3	10.19
Prime Rate:				19.5	20.5	17.5	16.5	16.5	15.0	12.0	11.0

Source: Federal Reserve, Statistical Release E.2; The State of Small Business: A Report of the President, Transmitted to the Congress, March 1983, page 231. Updated by Office of Economic Research, Small Business Administration, May 1983.

REPORT ON BUSINESS BANKRUPTCIES

Prepared by National Small Business Association -- September 21, 1981

Business Failures: Current Statistics

From mid-1980 to mid-1981 court-filed business bankruptcies increased 30.1 percent. This is the second largest year-to-year rise of the past 20 years, below only the 45.2 percent increase occurring between 1974 and 1975.

Even more alarming are more current figures from Dun & Bradstreet for January 1 through September 3, 1981, which reflect that business bankruptcies increased from 7,812 to 11,076, a jump of 41.8 percent compared with the same 35 week period in 1980, according to press reports quoting Rowena Wyant, a D&B Vice President in the New York business economics division ("Business Failures Increase," New York Times, September 13, 1981.)

Smaller businesses (defined as those with liabilities of $100,000 or less) comprised 50.53 percent of the 1981 total.

An industry breakdown of the D&B figures for the 35-week period is as follows:

1981 Compared to 1980	
Construction	up 48.5%
Services	up 47.6%
Retailing	up 41.4%
Manufacturing	up 36.9%
Wholesaling	up 30.1%

This information is probably conservative from the small firm standpoint, because D&B figures do not include the finance, insurance, and real estate fields where smaller businesses predominate.

In a recent newspaper column George Will characterized similar figures as "a massacre on Main Street." (The Massacre on Main Street," Washington Post, September 20, 1981, page C8:1)

The court filings are on the basis of the "statistical year" of the U.S. Courts which record the information, which for the past two years has been as follows:

Statistical Year July 1, 1979 - June 30, 1980 = 36,433
Statistical Year July 1, 1980 - June 30, 1981 = 47,414

Notes

As a technical matter, it should be noted that courts also accept Joint Petitions. These are additional filings where the husband and wife both participate in the enterprise. These are excluded from the above figures, because a "joint petition" covers persons associated with a business that has already filed. Inclusion of joint petitions would increase the business total for the 1980-81 statistical year to 66,000.

The statistics are also affected by changes in the bankruptcy laws brought about by the Bankruptcy Reform Act of 1978 (effective October 1, 1979). The new code did not make it easier for corporations to file. The law did establish a series of personal exemptions in federal law for the first time which, in many instances, were more liberal than state laws. (Bankruptcy Code, Sec. 522). However, there were not and are not any corporate exemptions, and corporations can no longer be discharged of debt as they could under the old law.

Historical Trends

The statistics on bankruptcies since 1950, as collected by both the U.S. Courts and Dun & Bradstreet are set forth in a chronological table attached as Exhibit 1.

The data show that business bankruptcies have risen and fallen in cycles. From mid-1961 through mid-1970, court-filed bankruptcies by businesses held almost constant (averaging about 16,200 per year, or 1350 per month). Then from mid-1971 to mid-1976, the figure more than doubled to 35,201 (about 2900 per month). Thereafter, the level declined until the end of 1979, when it stabilized at about 2,500 per month, as shown in the following table:

Court filed bankruptcies mid-1975 to mid-1979

1975-76	35,201
1976-77	32,189
1977-78	30,528
1978-79	29,500

Within a few months after the Federal Reserve action of October 1979 boosted interest rates to then-record levels, business bankruptcies began to climb dramatically. Totals reached an average of about 3,800 per month in the spring of 1980, where they remained until this year (1981) when they hit a new plateau of about 4,000 per month. This can be seen in the following quarterly tabulations:

	July-September	October-December	January-March	April-June
Statistical Year 1980-81	11,674 ('80)	11,227 ('80)	12,101 ('81)	12,081 ('81)
Statistical Year 1979-80	8,457 ('79)	7,014 ('79)	9,137 ('80)	11,473 ('80)

Thus, the business bankruptcy level increased 63.57 percent from the beginning of October, 1979 to the end of June, 1980.

Particularly Hard-Hit Industries

Some industries are particularly hard hit, such as construction. According to Dun & Bradstreet, bankruptcy rates for building contractors and subcontractors increased 48.5 percent through September 3, 1981 over the same period in 1980 (by which time the casualty figures had already risen substantially from the 1979 lows.)

A break-out of comparable figures for the first three months of this year shows:

Failure in Building and Construction

	January-February-March 1981	January-February-March 1980	Increase #	Increase %
General Building Contractors	282	228	54	23.68
Building Subcontractors	358	218	140	64.22
Other Contractors	45	22	23	104.55
	685	463	222	47.95

Source: Dun & Bradstreet, New York.

In automobile distribution, 1650 new car dealers went out of business in 1980, the largest total ever. Another 325 have failed during the first 6 months of 1981, bringing the overall exodus close to 9 percent of all businesses in this field since 1979 (NADA Data for 1981, National Association of Automobile Dealers).

"Walkaways"

There are also innumerable instances when businesses just close their doors and terminate the business. They may now owe creditors nothing. Or, they may have substantial debts which are satisfied through attachments on bank accounts or foreclosing tax liens or mortgages, leaving few assets for general creditors to pursue in any kind of formal proceeding. There is probably no overall source of statistics on these "walkaways," but experts believe the number is substantial.

Relationship Between Individual Bankruptcies and Business Bankruptcies

Court-filed bankruptcy rates for individuals have more than doubled since the new bankruptcy code became effective in October 1979:

Non-Business Bankruptcies

1978-79	196,976
1979-80	314,856
1980-81	450,000 (preliminary)

These personal bankruptcies have direct ramifications for small business.

When an individual declares bankruptcy, the creditors are left "holding the bag," which is almost always empty.

Prominent among these creditors are the retailers, distributors, builders and service enterprises where the bankrupt ran up the bills which caused the problems. Many of these are small business.

For example, the May Company reported 1980 losses increasing 103.3 percent to $3.6 million compared to 1979. For J.C. Penney, losses increased 102 percent to $20.7 million. Montgomery-Ward's losses increased 117 percent to $50.6 million, while Sears' losses increased 120.4 percent to $46.2 million for the same period.

Local businesses have the same kind of trouble. In fact, some of the regional independent stores, which are members of the National Retail Merchants Association, reported 1980 losses increasing over 200 percent compared to 1979.

Relationship Between Interest Rates and Bankruptcies

These cycles raise the question of how interest rates affect bankruptcies. As can be seen from comparing interest rate movements with the bankruptcy cycles documented by Dun & Bradstreet and the U.S. Courts, bankruptcies have tracked the interest rate very closely in recent years. This is illustrated by the chart attached as Exhibit 2, which was prepared by the Small Business Committee of the U.S. House of Representatives.

In technical terms, the correlation between real interest rates e.g., the nominal rate minus the inflation rate [GNP deflator] was 74.5 percent during the 3-year period coverd by the chart and 73.47 percent for the 5 years from 1976 to 1981. Economists say that 74 percent constitutes a "direct and significant correlation" between these two factors.

Higher interest rate movements can affect a business directly and indirectly in several ways. They add to the costs of financing the production, distribution, inventorying and sale of merchandise. They are also a factor in willingness of consumers to purchase the product.

Interest rates also impact general economic conditions with multiple effects on small firms.

A statistical "correlation" does not spell out *how* two factors relate to each other or what other factors may be involved. But a correlation does indicate some kind of a relationship -- in lesser or greater degree -- and a correlation as high as 74 percent indicates the relationship is close and meaningful.

The plight of industries composed mostly of small firms which are particularly sensitive to interest rates -- such as builders and auto dealerships -- tend to confirm this relationship.

Thus, as long as interest rates remain at record rates, it can be expected that bankruptcies will also continue to set new records.

Effects on Employment

The fifteen million small firms in the U.S. which file tax returns account for 55 percent of existing employment (59 percent if farming is included) and approximately 80 percent of all new jobs. Professor David Birch of M.I.T. found that independent enterprises with 20 or fewer employees accounted for 52 percent of net new private sector jobs between 1967 and 1976. Thus, as bankruptcies increase among small firms, job generation may be inhibited, existing jobs threatened, and increased unemployment may result.

Since each one percent increase in the unemployment rate (approximately equal to one million persons) deprives the U.S. Treasury of $25 to $29 billion in tax revenues foregone and benefits paid, increased bankruptcies -- especially among small businesses -- can translate into larger budgetary and economic problems.

The Human Dimension of Bankruptcies

Several years ago, a doctor at Johns Hopkins University researched the social effects of unemployment ("Estimating the Social Costs of National Economic Policy: Complications for Mental and Physical Health" by Professor Harvey Brenner, Joint Economic Committee Print, October 26, 1976).

This study found that during periods of higher unemployment, use of alcohol, hospitalization, suicides, heart attack and kidney disease also showed statistical increases.

Such an analysis could apply not only to employees, but to small business owners. Entrepreneurs would also be subject to great financial and personal stress in attempting to save businesses in which they have invested a significant amount of their savings and their careers, especially if these efforts were unsuccessful.

According to an attorney who has practiced bankruptcy law for 42 years, Samuel Greenbaum of Washington D.C., many small businesses are under-capitalized to begin with. As a result, such owners are often required to put up personal assets such as their homes as additional security for business loans. If a bankruptcy follows, an owner can also have his family life shattered, exacting a "toll of personal tragedy".

The surge in business failures is therefore of great concern for both economic and social reasons.

###

Exhibit 1

BUSINESS FAILURES

According to U.S. Courts

1950	8,352
1951	7,387
1952	6,542
1953	6,772
1954	8,888
1955	9,185
1956	9,478
1957	10,144
1958	11,403
1959	11,729
1960	12,284
1961	15,241
1962	15,665
1963	16,303
1964	16,510
1965	16,910
1966	16,430
1967	16,600
1968	16,545
1969	15,430
1970	16,197
1971	19,103
1972	18,132
1973	17,490
1974	20,747
1975	30,130
1976	35,201
1977	32,189
1978	30,528
1979	29,500*
1980	36,443*
1981	47,414*

According to Dun & Bradstreet

1950	9,162
1951	8,058
1952	7,611
1953	8,862
1954	11,068
1955	10,969
1956	12,686
1957	13,739
1958	14,964
1959	14,053
1960	15,445
1961	17,075
1962	15,782
1963	14,374
1964	13,501
1965	13,514
1966	13,061
1967	12,364
1968	9,363
1969	9,154
1970	10,748
1971	10,326
1972	9,566
1973	9,345
1974	9,915
1975	11,432
1976	9,628
1977	7,919
1978	6,619
1979	7,564
1980	11,742
1981 (through 12/31)	17,043

* Exclusive of Joint Petitions

Exhibit 2

BUSINESS FAILURES AND PRIME RATE

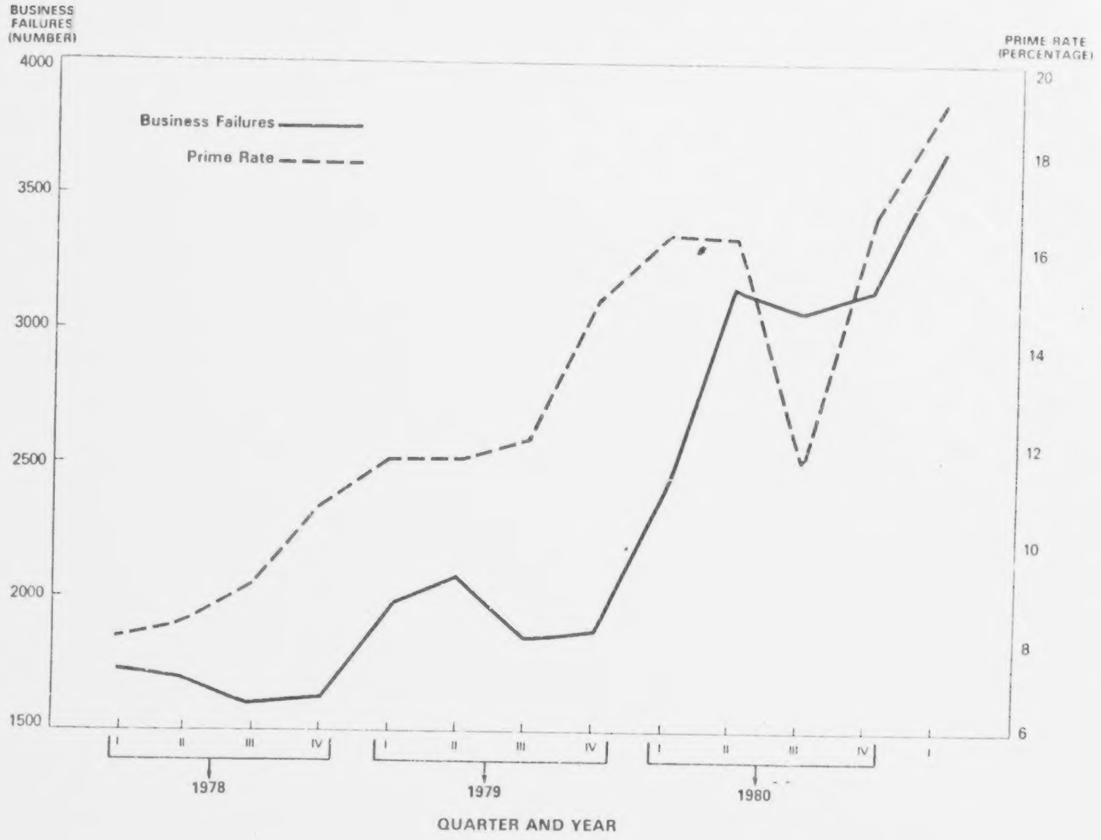

EXHIBIT C

BUSINESS FAILURES: 1920 - 1983
(Dun & Bradstreet Reports)

YEAR	NUMBER	YEAR	NUMBER
1920	8,881	1950	9,162
1921	19,652	1951	8,058
1922	23,676	1952	7,611
1923	18,718	1953	8,862
1924	20.615	1954	11,086
1925	21,214	1955	10,969
1926	21,773	1956	12,686
1927	21,146	1957	13,739
1928	23,842	1958	14,964
1929	22,909	1959	14,053
1930	26,355	1960	15,455
1931	28,285	1961	17,075
1932	31,822	1962	15,782
1933	19,859	1963	14,374
1934	12,091	1964	13,501
1935	12,244	1965	13,514
1936	9,607	1966	13,061
1937	9,490	1967	12,364
1938	12,836	1968	9,636
1939	14,768	1969	9,154
1940	13,619	1970	10,748
1941	11,848	1971	10,326
1942	9,405	1972	9,566
1943	3,221	1973	9,345
1944	1,222	1974	9,915
1945	809	1975	11,432
1946	1,129	1976	9,628
1947	3,474	1977	7,919
1948	5,250	1978	6,619
1949	9.246	1979	7,564
		1980	11,742
		1981	16,794
		1982	25,346
		1983	31,334

EXHIBIT D

TABLE I-5. BASELINE BUDGET PROJECTIONS UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS (By fiscal year)

	1984	1985	1986	1987	1988	1989
In Billions of Dollars						
Revenues						
High-growth alternative	668	750	825	913	1024	1137
CBO baseline projection	663	733	795	863	945	1016
Low-growth alternative	660	727	754	782	843	890
Outlays						
High-growth alternative	850	917	995	1089	1202	1323
CBO baseline projection	853	928	1012	1112	1227	1342
Low-growth alternative	856	936	1020	1112	1200	1280
Unified Budget Deficit						
High-growth alternative	182	168	170	176	178	186
CBO baseline projection	190	195	217	248	282	326
Low-growth alternative	196	209	267	329	357	390
As a Percent of GNP						
Revenues						
High-growth alternative	18.6	18.8	18.8	18.9	19.2	19.2
CBO baseline projection	18.6	18.7	18.7	18.7	19.0	18.9
Low-growth alternative	18.6	18.8	18.5	18.5	18.6	18.7
Outlays						
High-growth alternative	23.7	23.1	22.7	22.6	22.6	22.4
CBO baseline projection	23.9	23.7	23.8	24.1	24.6	24.9
Low-growth alternative	24.1	24.2	25.0	26.2	26.5	26.9
Unified Budget Deficit						
High-growth alternative	5.1	4.2	3.9	3.7	3.3	3.1
CBO baseline projection	5.3	5.0	5.1	5.4	5.6	6.1
Low-growth alternative	5.5	5.4	6.5	7.8	7.9	8.2

Source: Congressional Budget Office

EXHIBIT E

Excerpts from Testimony of American Institute of Certified Public Accountants to Senate Small Business Commitee on Effects of Banking Consolidation, February 25, 1983:

> "Other factors also are tending to make bank loans less available to small businesses than they should be.
>
> "We refer specifically to the continuing decline of small and local banks. Smaller banks provide approximately three-fourths of all commercial loans to small business. Traditionally, the smaller bank, knowing the character and history of its customers, typically honors its close working relationship with them.
>
> "The recent trend toward consolidation within the banking industry jeopardizes this relationship. As local banks become branches or subsidiaries of larger organizations, they tend to put greater emphasis on achieving the maximum return on their lendable funds, often the the detriment of businesses in the communities which provide those funds.
>
> "Aggravating this tendency is the frequent practice of large banking organizations to rotate their personnel, interrupting long standing personal relationships. Lending decisions are based more than ever on documentary evidence of financial stability, and less on the customers' integrity and reputation within the community, and on the bank's interest in and obligation to the community. Another factor that tends to diminish banks' interest in lending to small businesses is the convenience and high return available from financial center certificates of deposit and other money market instruments." ("Small Business Issues and Priorities -- 1983", Committee on Small Business, U.S. Senate, February 25, 1983, page 573 - 580.)

Mr. **Mitchell**. Thank you very much.

We will now hear from Mr. Dumas and Miss Andrea Mack. I am going to ask that I be excused for just 10 minutes. I was expecting a rather important call in my office, which is close, and as quickly as I can get there, I'll come right back.

Congressman Hayes, will you take the chair.

Mr. **Hayes** [presiding]. Would the next witness proceed.

TESTIMONY OF ANDREA MACK, LEGISLATIVE COUNSEL, NATIONAL ASSOCIATION OF MINORITY CONTRACTORS; ACCOMPANIED BY JUNIUS DUMAS, J. L. DUMAS & CO.

Ms. **Mack**. Good afternoon. I am Andrea Mack, legislative counsel for the National Association of Minority Contractors. To my right is J. L. Dumas, who is a general contractor from Detroit, Mich., who will testify on his company's experience with financial institutions in the Detroit metropolitan area.

On behalf of our national membership and constituents, we would like to thank you for the opportunity to testify before you today.

The National Association of Minority Contractors is a full service, nonprofit minority business trade association, established in 1969, to address the needs and concerns of minority construction contractors nationwide.

We feel that our testimony would best serve the informational needs of the committee if it is tailored to reflect the concerns of our members and constituency. We ask that our prepared statement be made a part of the record.

Mr. **Hayes**. As the Chairman has already indicated, it will be made a part of the record.

Ms. **Mack**. Thank you.

The rising trends in the rates of inflation, unemployment, and interest rates in the not so distant past are well known. While the effects of these trends impacted upon the general business community, they have exacerbated the already dismal business climate of minority entrepreneurs.

Undercapitalized firms are hurt most during periods of recession as a result of the increased inaccessibility to financing and credit. Moreover, higher supply costs, interest rates and wages that are characteristic of inflationary periods further weaken minority businesses' competitive position.

While economic revitalization programs already in place may benefit both majority and minority owned businesses, their greatest value in the short run will be to majority firms. Current programs are primarily aimed at larger capital-intensive corporations. Minority businesses, on the other hand, are small and are, for the most part, labor-intensive.

In order to continue to promote a sustainable economic recovery, minority businesses must be allowed to participate in the revitalization process. Minority owned businesses have the potential to help solve some of society's most intractable problems, including minority unemployment and the decaying of America.

Today, one of the most pressing problems facing States and cities is the need to rebuild and repair a huge part of their public capital, the infrastructure problem. The rehabilitation, construction and maintenance of infrastructure is crucial, not just to the Nation's municipalities, but to the country as a whole.

Yet, there has been a steady decline in public works spending. The rate of capital investment as a percent of GNP has dropped from 3.3 percent or more in the 1960's to 2.1 percent in 1982. This decline has had a devastating impact on contractor opportunity in the already depressed construction industry. As a result, unemployment in the construction industry has been running over 20 percent, which is double the national rate.

The recently enacted Surface Transportation Assistance Act addresses both the unemployment problem and the infrastructure problem as it relates to the rebuilding of our Nation's highways, bridges, and mass transit systems. Of particular interest to minority contractors is section 105(f), which provides that not less than 10 percent of the funds authorized be expended with small business concerns owned and controlled by socially and economically disadvantaged individuals.

Even though the amendment was intended to insure that minorities participate as fully as possible in the economic benefits resulting from the act, it is anticipated that a variety of problems will occur that will dilute its overall impact. Perhaps the greatest problem that minority owned businesses will face is their inability in obtaining working capital.

At this point I would like Mr. Dumas to talk about the problems that he has been experiencing in Detroit in obtaining working capital.

Mr. Dumas. Good afternoon. I am a general contractor in Detroit and we are currently working on the downtown people mover project, which is a $160 million transit project in the city of Detroit.

One of our roles in that project is to coordinate the MBE/WBE participation on the project, in which there is about $16 million that we have identified for small and minority business to be performed under that contract. I have a contract of about $2.5 million, and I have been involved in the project for about a year and a half. To date, I have been unable to secure any financing in terms of working capital to fund my own contract, which is about $2.5 million. Even though the project is in effect and the work is going on and there is a proven record of being paid, the banks are totally noncommitted and unsympathetic to doing business with small businesses in the Detroit area whatsoever.

We have a lot of programs going on in which you are indicating you want to get more small businesses involved. Yet still, as we go to the banks and financial institutions, or to SBA and ask for assistance in terms of loans, we are being turned down either because the money isn't there in the kitty for small business or the banks have decided they want to go with AAA, number one companies, to finance. All of the companies that fall below that area are not getting any benefit whatsoever. We find that to be a major problem that we're experiencing right now.

Ms. Mack. What Mr. Dumas has said is a prime example of the insensitivity of these financial institutions. That is why we are quite concerned about the total deregulation of the banking industry, which could possibly lead to the obliteration of the local community-based banks by merger and acquisition.

The higher interest rates that minority contractors pay for capital will further constrain their participation in the program under the Surface Transportation Act.

While there has been a significant drop in short-term interest rates, small businesses, however, are still facing extremely high, real short-term interest rates because of the higher business risk premiums that lending institutions have historically added to small and minority business loans. As a result, minority contractors are completely forced out of the capital market and left without the required financing to compete. Mr. Dumas will tell us some problems he has experienced in this area.

Mr. DUMAS. Generally, the general contractors, at least our firm, hire between 20 and 30 professional employees. We have anywhere, in terms of skilled trade persons, from 10 to 90 employees and subcontractors. That requires a substantial amount of cash flow to fund the projects until we get our capital in from our billing process. I think most people know that the Government is relatively slow in paying their bills. In fact, there is slow payment in the industry right now across the board. For us to compete and to benefit from any opportunities, we must have capital available to us. It seems that every direction we tend to go to for that support, we are not able to get it. It affects the ability for us to bid on work competitively because when we're bidding work we have to put in an additional factor for the high interest rates which, in some cases, prices the project beyond what is considered the level it should be at.

Ms. MACK. In closing, we have several recommendations. NAMC stresses the importance of pursuing economic policies which reduce the cost of capital investment to State and local governments so that they can meet the infrastructure needs of America. An expanding State and local construction market will give small and minority firms a chance to compete against larger, more established firms, for a larger slice of an increasing pie. This is especially important for 8(a) firms which have been tacitly encouraged to depend upon Federal largesse but are now faced with legislation that limits their tenure in the sheltered market program.

We also would like to stress the importance of pursuing economic policies which reduce the cost of capital to small and minority contractors. We would like to reiterate Dr. Bradford's recommendation concerning raising the ceiling on SBA's loan guarantee program.

Mr. DUMAS. One other item that we also would like to recommend, and that is that some enforcement process goes into effect so that the financial institutions in these areas will, in fact, lend to small and minority businesses, because they again have totally turned their backs on us.

Thank you.

[Ms. Mack's prepared statement with attachment follows:]

PREPARED STATEMENT OF ANDREA MACK, LEGISLATIVE COUNSEL, NATIONAL ASSOCIATION OF MINORITY CONTRACTORS

Mr. Chairmen and members of the committee, on behalf of our national membership and constituents, I would like to thank you for the opportunity to testify before you today on the issue of high real interest rates and their potential effect on the economy and small business.

The National Association of Minority Contractors (NAMC) is a full service, nonprofit minority business trade association, established in 1969, to address the needs and concerns of minority construction contractors nationwide. Currently, NAMC's membership, comprised of blacks, Hispanics, women, and Asians, covers 37 States, the District of Columbia, and the Virgin Islands. NAMC is headquartered in the Nation's Capitol, and includes general contractors, subcontractors, construction managers, manufacturers, construction suppliers, local minority contractor associations, funded technical assistance organizations, and other associated organizations.

Rather than addressing the above-mentioned issue generally, we feel that our testimony would best serve the informational needs of the committee if it is tailored to reflect the concern of our membership and constituency.

MINORITY BUSINESS IN TODAY'S ECONOMY

The history of racial/ethnic minorities in the United States is generally one of inequity and marginal access to paths of upward mobility. In almost every category of status, advantage or economic well-being, they are greatly under-represented. This can be seen clearly when one examines the limited degree to which minorities participate in mainstream economic activity.

The rising trends in the rates of inflation, unemployment, and interest rates in the not so distant past are well known. While the effects of these trends impacted upon the general business community, they have exacerbated the already dismal business climate of minority entrepreneurs.

Undercapitalized firms are hurt most during periods of recession as a result of the increased inaccessibility to financing and credit. Moreover, higher supply costs, interest rates and wages that are characteristic of inflationary periods further weaken minority business' competitive position.

While economic revitalization programs already in place may benefit both majority and minority-owned businesses, their greatest value in the short run will be to majority firms. Current programs are primarily aimed at larger capital-intensive corporations, with an emphasis on capital accumulation. Minority businesses, on the other hand, are small, i.e., 99 percent have assets of under $1 million, and are, for the most part, labor-intensive.

In companies of this type, the advantages of such programs as accelerated depreciation and research and development tax credits are almost nonexistent. Similarly, reductions in income taxes and estate and gift taxes are of little value, since most minority business owners are in the lower tax brackets already.

In order to continue to promote a sustainable economic recovery, minority businesses must be allowed to participate in the revitalization process. Minority owned businesses have the potential to help solve some of society's most intractable problems including minority unemployment and the decaying of America.

THE IMPACT ON CONTRACTOR OPPORTUNITY

Today, one of the most pressing problems facing States and cities in the need to rebuild and repair a huge part of their public capital—the infrastructure problem. It has become well known that we have serious deficiencies in our highways, bridges, rail systems, urban transit systems, ports, inland waterways, dams, urban water systems, and waste treatment systems. The rehabilitation, construction, and maintenance of infrastructure is crucial not just to the Nation's municipalities but to the country as a whole. American business and farming depend on the smooth functioning of public works. If producers cannot get their products to market on time, prices increase and competitiveness declines. If basic services such as water supply or sewage are limited, then firms are hampered in their ability to expand and provide more jobs and income.

Yet, there has been a steady decline in public works spending. The rate of capital investment as a percent of GNP has dropped from 3.3 percent or more in the 1960's to 2.1 percent in 1982. (See table 1) This decline has had a devastating impact on contractor opportunity in the depressed construction industry. As a result, unemployment in the construction industry has been running over 20 percent-double the national rate. Furthermore, minority contractors, who have always been the ones who physically build the roads, bridges, and buildings, have found it increasingly difficult to participate in the government procurement process, including the sheltered market.

TABLE 1.—GOVERNMENT EXPENDITURES FOR CAPITAL INVESTMENT

[In constant 1981 dollars]

	Federal direct	Federal grants-in-aid	State and local	Total	As a percent of GNP
Year: [1]					
1961	$6.4	$8.5	$33.8	$48.7	3.3
1963	7.8	9.5	38.4	55.7	3.4
1965	9.3	13.0	42.7	65.0	3.6
1967	8.5	12.5	53.1	74.1	3.7
1969	6.3	13.5	55.3	75.0	3.5
1971	7.0	14.2	51.7	72.9	3.3
1973	8.5	14.5	49.7	72.9	3.0
1975	7.9	14.1	51.2	73.2	3.0
1977	8.7	22.9	30.9	62.5	2.3
1979	9.7	23.6	34.0	67.3	2.3
1981	9.9	22.2	33.5	65.6	2.2
1982 estimated	9.0	20.5	29.7	59.2	2.1
1983 estimated	7.6	17.3	[illegible]	[illegible]	[illegible]

[1] Deflated with the "gross private domestic fixed investment deflator." For 1982 and 1983, estimates assume 6 percent annual growth in the fixed investment deflator.

Source: U.S. Office of Management and Budget, Budget of the U.S. Government, Special Analysis; U.S. Department of Commerce, The National Income and Product Accounts of the U.S., 1929–76 Statistical Tables, and the Survey of Current Business, (July 1982); and staff calculations. Adapted from the testimony of Arnold Carter, Assistant Director, Department of Economic Research, American Federation of Labor and Council of Industrial Organization, before the Subcommittee on Economic Development, Committee on Public Works and Transportation, U.S. House of Representatives, May 3, 1983.

The recently enacted Surface Transportation Assistance Act addresses both the unemployment problem and the infrastructure problem as it relates to rebuilding our Nation's highways, bridges, and mass transit systems. Of particular interest to minority contractors is section 105(f) which provides that not less than 10 percent of the funds authorized be expended with small business concerns owned and controlled by socially and economically disadvantaged individuals. Even though the amendment was intended to ensure that minorities participate as fully as possible in the economic benefits resulting from the act, it is anticipated that a variety of problems will occur that will dilute its overall impact. Perhaps the greatest problem that minority-owned businesses will face is their inability in obtaining working capital. Minority entrepreneurs rarely have enough personal wealth to finance their own businesses. Majority-owned financial institutions are generally reluctant to take "risks" associated with investments in minority businesses. On the other hand, minority financial institutions, who have a far better record than non-minority institutions in lending to minority businesses, sometimes lack sufficient assets to serve as a major source of capital. Moreover, they are more consumer oriented, with little experience in dealing with the current and future financial needs of minority contractors.

Notwithstanding the above, we recognize that minority financial institutions are a major source of financing for small businesses. We are, therefore, quite concerned that total deregulation of the banking industry could lead to the obliteration of local community based banks by merger and acquisition.

Additionally, the historically higher interest rates that minority contractors pay for capital will further constrain their participation in the program. Because many small businesses tend to be undercapitalized or face substantial capital needs to finance growth, real high interest rates can cause severe cash flow problems for these firms. So, understanding the origin of high interest rates is critical to our review today.

INTEREST RATES

While there may be some link currently and perhaps in the future to high deficits and high interest rates, historically the closer connection has been between interest rates and inflation. When the inflation rate is high, interest rates are pushed up directly by the need for bankers to add an inflation premium to protect the real value of the funds they lend. In addition, the economic instability suggested by the presence of high rates of inflation leads to a larger premium in the cost of capital as well. As a result, minority contractors are completely forced out of the capital market.

As a direct result of the stern economic measures the President, the Congress, and the Federal Reserve Board undertook in 1981, the inflation rate has dropped from 11.7 percent in 1981 to approximately 3.2 percent in 1983. As a result, there has been a significant drop in short-term real interest rates over what they were before these measures were taken. From a high of 21.5 percent four years ago, the prime rate was cut in half and has remained steady at 11.0 percent during the past year.

What remains puzzling is why interest rates have not dropped further. Again, reasonable interest rates should be the total of three factors: (1) a fair rate return on capital, say three or four percent; (2) an inflation premium, say 3.5 percent; and (3) an economic risk premium. Given that the rate of inflation has been steady and most economists believe it will remain steady for the next year, the difference then between more desirable interest rates in the 8 or 9 percent range and what we have now, and most importantly for this hearing, what we will have in the future, is either lending institutions seeking higher than normal rates of return on their capital or these institutions exacting a larger than expected economic risk premium or both.

Leaving aside the matter of the possibility of profit maximization, let me focus on the question of the concerns of financial markets about the economy.

HIGH DEFICITS

Historically, the lack of confidence financial markets might have had about our economic future have focused more on inflation and the rate of growth in the money supply than they have about deficits. There was a general complaint four years ago that monetary policy shifted too often, that money was too tight, and that very high interest rates were the result.

Today, many things have changed. Inflation is down, gone are the erratic changes in the money supply, unemployment has been declining, but what has not changed is uncertainty in financial markets about the economy. Today, deficits have replaced inflation and money supply as the principal source of uncertainty. While that uncertainty has not been translated into higher interest rates yet, if talk about deficits outpaces action it could do so in the future. Meanwhile, the uncertainty is one of the reasons why rates have not fallen to lower levels now.

Deficits will become a problem for small business if the growth in Federal claims on capital markets to finance the deficit outpaces the growth in those markets sparked by economic recovery. One of the reasons we believe deficits have not been a problem thus far is the tax cuts and tax reforms have made savings and investment more attractive to more Americans and that has led to greater investments. Even as Uncle Sam dips deeper into the pool of capital to satisfy the deficit, earlier reforms are deepening the pool.

We believe the real concern of small business is what is done about the deficits. If the Federal Government increases taxes too sharply to bring the budget into balance, it will reduce savings rates and investment capital availability to such an extent that the pool of capital that all of us utilize will shrink and the negative impact on the pool caused by deficits will increase dramatically. In other words, if we raised taxes by $200 billion a year to close the budget gap, NAMC is concerned that this would dry up investment to such an extent that small businesses would be crowded out of financial markets. The effect of this could be devastating, given the special role in job creation that small businesses play in the American economy.

Congress and the President need to exercise extreme caution in both relying too much on either taxes or expenditure cuts in bringing the budget into line. Excessive social cuts would hurt many of the persons that the minority small business community seeks to help. A balanced approach must be found.

CONCLUSION

NAMC stresses the importance of pursuing economic policies which reduce the cost of capital investment to State and local governments so that they can meet the infrastructure needs of America. An expanding State and local construction market will give small and minority firms a chance to complete against larger, more established firms for a larger slice of an increasing pie. This is especially important for 8(a) firms which have been tacitly encouraged to depend upon federal largesse but are now faced with legislation that limits their tenure in the sheltered market program.

The maintenance or reduction of the current rates of interest will depend on continuing control of inflation and the money supply and the combined commitment by the President and the Congress to increase financial community confidence in the future of the economy by undertaking budget balancing initiatives that do not dry up current sources of investment nor cut too heavily into existing Government programs.

J. L. Dumas & Co.,
Detroit, Mich., March 6, 1984.

Hon. Parren J. Mitchell,
Chairman, Committee on Small Business, Congress of the United States, House of Representatives, Washington, D.C.

Dear Mr. Mitchell: I am writing in response to questions raised in your letter of February 7, 1984, to Mr. Dewey Thomas, Jr., Executive Director, National Association of Minority Contractors. I would like to take this opportunity to provide you with specific examples of the problems faced by Minority contractors, such as myself, resulting from the recent recession and the depressed economic business climate in the construction industry.

It is my hope, that by providing clear examples of case history, you will be further prepared in your continuing endeavors to highlight and correct the disparities with respect to small business and Minority participation in the mainstream of the free enterprise system.

Following is a response to issues raised in your correspondence to Mr. Thomas:

Question. How were small contractors affected by the recent recession?

Answer. Over the last 3½ years small and Minority contractors experienced:

—Dramatic decreases in business opportunities in the private and public sector.

—Fierce competition with major competitors, who were in some cases, bidding work below costs to maintain cash flow for their operations.

—Affirmative Action—enforcement relaxation.

—Private business is opting and electing to give business opportunities to longtime acquaintances, and relaxing their policies in making business opportunities available to small and minority contractors who, in some cases, were only recently afforded an opportunity to participate in the private sector procurement programs.

—Small contractors, in a growth position pre-recession, found it nearly impossible to procure sufficient business volumes to maintain and service their overhead needs. There has been an erosion of the assets and working capital that had been previously amassed in small businesses. These represent a few of the effects of the recession on small and minority contractors.

Question. Has credit been available to small contractors at reasonable rates and terms over the past few years? Is credit available at the present time and at what interest rates?

Answer. Our experience has shown that credit has not been available to small contractors at reasonable rates and terms over the past few years. Overall, credit is not available at any interest rate due to the current restrictive financial banking policies in our region of the country and secondly, due to the nature and high risk factors of the construction industry.

The recent deregulation of the banking industry has spawned a trend whereby financial institutions no longer cater to the needs of their immediate community, but aggressively seek to obtain the business of larger and more stable business entities on a region-wide basis. This is evidenced by a review of the portfolio's of major financial institutions in our region of the country.

Question. How have high interest rates affected the level of State and Local government's investment in the construction and repair of highways, bridges, and other public facilities?

Answer. The high interest rates, specifically those charged to Minority contractors, has affected the following:

—Ability to be cost competitive and effective in their bidding.

—Due to an inability to obtain credit, it has affected their ability to finance projects targeted or mandated by government legislation for procurement by MBE/WBE firms.

—It has effectively slowed the rate of employment opportunities that would have been generated through growth and expansion.

Question. Have some contractors experienced financial difficulty because of increased competition for a reduced dollar level of State and Local investment in the construction and repair of public facilities.

Answer. Yes. Statistics show that the Minority business volume over the last 3½ years, in both the public and private sector, has dramatically decreased proportionate to the overall growth in the industry. We feel this is a direct result of the factors mentioned above.

Question. What other special problems have small contractors faced over the past few years?

Answer. Other problems include Minority contractors not having access to finance and revenues needed to expand/procure business in geographical areas of the country where there is substantial growth in the construction area. Major firms expanded their market during this period.

Question. Is there anything the Federal government and SBA can do to assist Small and Minority contractors to obtain credit?

Answer Yes. SBA can increase the dollar volume and the funds available for SBA guaranteed loans.

—Federal and State governments can mandate and enforce laws requiring the financial institutions to make loans available to Minority and small contractors as part of their overall loan portfolio.

—Government can provide types of guarantees that may be needed to protect the financial institutions interest in servicing loans to small and minority contractors.

—Continue to request input from NAMC is providing the Small Business Committee with case history and input from the small and Minority contractor sector of the business community.

I thank you for your review of my submittal, and trust that it will be of assistance to you in your examination of problems faced by small and Minority contractors. I welcome the opportunity to continue the meaningful dialogue established with you. Best wishes for continued success in your endeavors.

Respectfully submitted,

J. L. DUMAS,
Fourth Vice-President,
National Association of Minority Contractors,
President, J. L. Dumas & Co.

Mr. HAYES. I would like to call on Congressman Luken here to introduce our next witness.

Mr. LUKEN. Thank you, Mr. Chairman.

I was actually unaware that Charlie Gilbert was going to be here until I saw it on the schedule. But he happens to be a friend and a neighbor of mine, so I am very privileged to briefly introduce him, not to take up any extra time.

Charlie is the head of the Gilbert Machine Tool Co., which is maybe the best one, but typical of a number of machine tool companies in the Cincinnati area. Cincinnati has been the machine tool capital of the world and, therefore, we're poignantly aware of the particular problems of this industry which has been targeted by some of our foreign competitors. It is also, I'm afraid, typical of what is happening in many areas, where we in the Midwest suffer because of the recession in the smokestack industries.

But I just want to say a word as to the obvious credibility of Charlie Gilbert, who has been in business so long that memory of man runneth not to the contrary. He has been a great contributor to not only the Midwest but especially to the Cincinnati community. So thank you, Charlie, for attending.

Mr. Chairman, could we ask him to proceed?

Mr. MITCHELL [presiding]. Of course. I think I have had the pleasure of meeting Mr. Gilbert, also, before.

Mr. LUKEN. That is something I did fail to mention. I didn't want to impose any additional burdens on the committee as far as time is concerned, but Charlie has not only been a good citizen, as far as producing good machine tools and jobs in the Cincinnati area, but he has been a frequent visitor here to Washington to tell us accurately what the situation is.

Mr. MITCHELL. Thank you, sir. If you will proceed.

TESTIMONY OF CHARLES E. GILBERT, JR., ON BEHALF OF THE NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION; ACCOMPANIED BY JAMES H. MACK, PUBLIC AFFAIRS DIRECTOR, NMTBA

Mr. GILBERT. Thank you.

My company is a member of the National Machine Tool Builders' Association, NMTBA, on whose behalf I am appearing this afternoon. Accompanying me is James H. Mack, NMTBA's public affairs director.

Mr. Chairman, we appreciate the opportunity to bring to your attention the serious threat currently facing one of this Nation's key industries, specifically, the U.S. machine tool industry. This forum is particularly appropriate because the U.S. machine tool industry is to a great extent comprised of small businesses.

Mr. Chairman, the last 2 years have been difficult for my company. Today we employ only 40 percent of the people we did 2 short years ago. Even more unfortunate is the fact that we typify the past 2½ years of retrenchment experienced by the U.S. machine tool industry—sustained decline following 6 years of strength. As my written statement demonstrates in detail, orders, shipments, and employment have each dropped dramatically.

The reasons for the industrywide decline are varied and complex. Certainly, the recent economic downturn and the decline in the Nation's rate of capital spending resulting from it have played a significant role. Even more significant, however, is the phenomenal influx of imported machine tools. Since 1964, America's imports of foreign machine tools has increased eightfold, from 4.5 percent of total consumption 20 years ago, to 34 percent, based on value, in the first three quarters of 1983. As a share of units—that is, machines actually installed—imports accounted for nearly 37 percent of U.S. consumption in 1983. The fact that we are losing an increasingly larger share of our domestic machine tool market to imports each year is, by itself, cause for concern. But perhaps even more disturbing is the changing character of that market share. It is increasingly comprised of more technologically advanced and defense-sensitive equipment.

Clearly the machine tool industry is vital to the defense of this country and its ability to respond in the event of a national emergency.

In response to the unprecedented and ever-rising tide of imports, on March 10, 1983, NMTBA filed a petition under the national security provision of the trade laws with the Secretary of Commerce seeking trade relief in the form of quotas upon metal-cutting and metal-forming machine tools imported into the United States.

The relief requested is intended to achieve specific national security objectives—restoration of the health of the domestic machine tool industry and expansion of its mobilization capability.

The relatively small size of the companies comprising the U.S. machine tool industry, and the constraints that its extreme cyclicality imposes on their financing and operation, have made this industry and the enormous American market that it primarily serves, vulnerable to targeting by foreign governments.

While orders have increased moderately from last year's levels, those levels were so extraordinarily low that even a modest increase looks big on a percentage basis. When the industry's section 232 petition was filed in March 1983, its net new orders were at their lowest level in over a decade in nominal dollars. Far more important, however, in real, inflation-adjusted dollars, orders had fallen to their lowest levels since the recession of the late 1940's. When expressed in real, inflation-adjusted dollars, however, the industry's economic position today can be shown to be more precarious than it was a year ago. It is from this 35-year low point that a small increase has taken place.

More importantly, even as the total machine tool market has declined over the past 3 years, the market share of imported machine tools continues to skyrocket.

If anything, the most recently available data support even more strongly the industry's contention that a curb on imports is urgently needed to assure the viability of a domestic machine tool industry capable of meeting our national security needs.

Even worse, since the cash flow of the industry is tied to shipments, not orders, the revenues from even the modest 1983 increases in orders will not reach machine tool companies for some time. In fact, shipments in the latest reported quarter—the third quarter of 1983—stand at the lowest level in real dollars since the end of World War II.

In my own company's case, while shipments began to decline in 1982, we were most severely impacted in 1983 when shipments dropped 56.4 percent from the previous years total. This closely parallels the industry's decline of 57.4 percent during the same period.

Although the industry has been able to rehire a few employees in 1983, we have hardly been able to make a dent. From April 1980 to July 1983, employment in the domestic industry plummetted from 110,200 workers to 64,600. This is an average job loss rate of over 1,100 persons per month for 40 months. By October 1983, the industry had rehired only 1,400 of these laid-off workers.

Notwithstanding currently discouraging economic circumstances, the U.S. machine tool industry has mounted a vigorous campaign of self-help described in detail in my full statement. However, because of the depth of the current recession and the scope of recent import penetration, the industry vitally needs the temporary import relief requested in NMTBA's section 232 petition. The quota relief requested by NMTBA would strengthen the support of shareholders and capital markets to allow the necessary sustained commitments of capital.

It is our understanding that on Tuesday of this week the Department of Commerce transmitted its report to the White House, well in advance of the March 14 statutory deadline. This places the decision squarely in the hands of President Reagan.

The relief requested will provide a stable and predictable environment in which the domestic machine tool industry can maintain and increase investment in capital equipment and technology.

Such stability and predictability depend crucially on an ability to anticipate import levels and thereby to plan investment during the relief period.

During the past year some government officials have suggested such steps as increased Federal funding for educational programs, increased Federal R&D expenditures for machine tool and manufacturing research, streamlining of export licensing procedures, changes to the Internal Revenue Code to stimulate greater capital investment, better export/import financing, and trade adjustment assistance as substitutes for the quotas requested in our petition.

While all these would be helpful, nearly all would require new budget authority or tax expenditures at a time of growing national concern over the huge Federal deficit. Moreover, they are not an adequate substitute for quantitative restriction of imports.

Sophisticated production processes and sophisticated weapon systems require a domestic machine tool industry that is at least equal to the world's best. As imports continue to rise, the U.S. machine tool industry, long the world leader, is in danger of losing its technological advantage as well as its production capacity. NMTBA submits, therefore, that under section 232 action must be taken to adjust the level of imports so that the U.S. machine tool industry can regain its competitive edge, thereby reducing the current threat to our national security.

Thank you, Mr. Chairman.

[Mr. Gilbert's prepared statement with attachments follows:]

PREPARED STATEMENT OF CHARLES E. GILBERT, JR., ON BEHALF OF THE NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION

I. INTRODUCTION

Good morning, my name is Charles E. Gilbert, Jr. I am President of the Cincinnati Gilbert Machine Tool Company of Cincinnati, Ohio.

My company is a member of the National Machine Tool Builders' Association (NMTBA), on whose behalf I am appearing this morning. Accompanying me today is James H. Mack, NMTBA's Public Affairs Director. NMTBA is a trade association consisting of over 287 American machine tool manufacturing companies, which produce approximately 85 percent of the machine tools made in the United States.

Mr. Chairman, we appreciate the opportunity to bring to your attention the serious threat currently facing one of this nations key industries; specifically, the U.S. Machine Tool Industry. This forum is particularly appropriate because the U.S. Machine Tool Industry is to a great extent comprised of small businesses. That is, companies with 250 or fewer employees. We are pleased to be a part of this forum, and hope that our comments this morning will be helpful to the Committee in its competitive assessment of U.S. small businesses and its role in helping to enhance and sustain our country's economy.

An extensive overview of the industry appears later in this statement. I will summarize that overview by simply saying that the machine tool industry is the cornerstone of the manufacturing process, and in particular, virtually all facets of military production. Unfortunately, the past two and one-half years have been years of retrenchment for the machine tool industry -- sustained decline following six years of strength. As this statement will document, orders, shipments and employment have each dropped dramatically.

In my own company's case, we are still in the bottom of the trough of this most severe recession. Translated into more human terms, our workforce today is only 40 percent of what it was only two short years ago.

The reasons for the industry-wide decline are varied and complex. Certainly, the recent economic downturn and the decline in the nation's rate of capital spending resulting from it have played a significant role. Even more significant, however, is the phenomenal influx of imported machine tools. Since 1964, America's imports of foreign machine tools have increased eight-fold from 4.5 percent of total consumption 20 years ago to 34 percent, based on value, in the first three quarters of 1983. As a share of units (that is, machines actually installed), imports accounted for nearly 37 percent of U.S. consumption in 1983. The fact that we are losing an increasingly larger share of our domestic machine tool market to imports each year is, by itself, cause for concern. But perhaps even more disturbing is the changing character of that market share -- our testimony will indicate that it is increasingly comprised of more technologically advanced and defense-sensitive equipment.

Clearly, the machine tool industry is vital to the defense of this country and its ability to respond in the event of a national emergency. NMTBA, therefore, firmly believes that the American machine tool industry can -- that it must -- regain its competitive edge.

In response to the unprecedented and ever-rising tide of imports, on March 10, 1983, NMTBA filed a petition under the National Security provision of the Trade Laws (19 U.S.C. §1862) with the Secretary of Commerce seeking trade relief in the form of quotas upon metal-cutting and metal-forming machine tools imported into the United States. More specifically, NMTBA requests a five-year regime of quotas limiting imports in each of the two broad sectors of machine tools to 17.5 percent of domestic consumption, measured by value. To preserve the domestic industry's capability to produce the complete range of major types of machine tools, NMTBA further requests that separate quotas be applied within these broad sectors so that imports of specific types of machine tools cannot exceed twenty percent of annual domestic consumption of each of 18 product types. In establishing and applying the quotas, care must be taken to ensure that they cannot be circumvented by the importation of unassembled machine tools or component parts in quantities that would effectively undermine the relief granted.

NMTBA also suggests that the government may wish to consider implementing the quotas on a monthly or quarterly basis to minimize the risk that foreign producers will disrupt the market by shipping a full year's quota to the United States early in the year. Imports of machine tools of one or more of the 18 product types would be permitted at levels between 17.5 percent and 20 percent of domestic consumption so long as the level of imports of other types was less than 17.5 percent of domestic consumption, provided that the sales-weighted average value of imports did not exceed 17.5 percent of domestic consumption in either the metal-cutting or the metal-forming sector.

These levels of quotas are intended to achieve specific national security objectives -- restoration of the health of the domestic machine tool industry and expansion of its mobilization capability -- as discussed below. The quotas are expressed in terms of value, instead of units, to prevent foreign producers from effectively increasing their market share by concentrating their shipments to the United States in the highest-priced models. It should be noted, however, that the quotas requested do not confine importers to any fixed dollar value of imports during the five-year period. Instead, they would allow importers to participate proportionately in any increase in U.S. consumption of machine tools.

II. DESCRIPTION OF THE MACHINE TOOL INDUSTRY

Machine tools are power-driven machines, not hand held, that are used to cut, form or shape metal. All machine tools can be broadly classified in either of the two principal families or sectors of machine tools: metal-cutting machine tools or metal-forming machine tools. These two sectors in turn encompass numerous types or categories of machine tools defined by their function and method of operation.

There are six basic categories of metal-cutting machine tools: drilling machines, milling machines, boring machines, turning machines (i.e., lathes), grinding and polishing machines, and sawing machines. Additionally, there are various types of special purpose metal-cutting machines that are based on these categories. Examples are machining centers, which combine drilling, milling and boring operations, and gear-cutting machines, which are special purpose milling machines. Another example, station-type machines, are machines that perform different metalworking operations at a succession of locations or "stations."

There are also six basic categories of metal-forming machine tools: punching machines, shearing machines, bending machines, forging machines, die-casting machines, and presses.

Metal-cutting machine tools. Among the metal-cutting machine tools, turning machines are distinct in that they operate by applying a stationary cutting edge to a rotating workpiece held in a chuck or similar device for the purpose of manufacturing a round product. Milling machines employ a rotating "cutter" to cut the surface of a stationary workpiece. Drilling and boring machines cut holes of various sizes in a workpiece. Grinding and polishing machines employ a grinding wheel to remove metal from a workpiece that may be either round or flat. Sawing machines saw metal to a desired design or cut a piece of metal from rough stock for further work.

Metal-forming machine tools. Metal-forming machine tools shape metal by applying force to it. Punching machines stamp designs out of sheet metal with the use of cutting dies. Shearing machines cut sheet metal with a blade that is applied to the metal with force. Bending machines bend sheet metal into cylinders, arcs and angles. Presses apply great force to bend, cut or punch metal. Forging machines compress pre-heated metal into a desired shape using dies. Die-casting machines inject molten metal into a die set to produce a complex shape by casting.

Uses of machine tools. Machine tools are capital goods used extensively in manufacturing articles comprised substantially of metal. For example, each automobile, locomotive, airplane, farm machine, appliance and most articles of military hardware require substantial machining on machine tools.

Machine tools also have an important, albeit indirect, role in the manufacture of numerous nonmetal products. For example, the pipes, valves and tubes required for chemical refineries are made on machine tools, as are the machines used to weave textiles and to process timber into lumber and other finished-wood products. In short, machine tools make numerous products including other machines and are the fundamental element of industrial production.

Size of the industry. The critical importance of machine tools for industrial production cannot be gauged by the size of the machine tool industry itself. The total production of machine tools in the United States during 1982 was $3.6 billion, which represented 0.12 percent of the gross national product. In 1983, impacted by the recession, machine tool output fell to just over $1.8 billion. This represented only .06 percent of the U.S. gross national product. The last Census of Manufacturers shows that in 1977 the machine tool industry was made up of 1,285 companies comprising 1,345 establishments, with industry employment then totaling 83,200. Nearly two-thirds of the establishments had fewer than 20 employees.

In both the metal-cutting and metal-forming sectors the 20 largest companies in the sector accounted for approximately 55 percent of sector shipments and the next 30 largest companies accounted for slightly over 20 percent of sector shipments. The industry is concentrated in the North-East and North-Central states.

Technological change. Like many other industries, the machine tool industry has been substantially affected by changes in technology and in manufacturing processes. These changes have implications for national security that are not, in the present state of affairs, reassuring. First, certain major customers of the machine tool industry have in recent years tended to order machine tools that are highly specialized in their uses and thus less easily adaptable to other uses. Such loss of flexibility harms our mobilization potential. Second, advances in technology have made it possible to produce sophisticated and more flexible machine tools (e.g., computer- or numerically-controlled ("CNC" or "NC") machining centers) that are required to make many products (such as modern weapons systems) involving new kinds of metals, tighter tolerances and greater complexity. In these circumstances, any foreign threat to the United States' technological leadership carries with it the risk that our national security will become dependent on foreign technology and sources of supply.

Cyclicality of demand. A longstanding characteristic of the machine tool industry that unfortunately shows no sign of changing is the extremely cyclical demand for machine tools. The level of orders for machine tools is determined primarily by industrial propensities to invest in capital goods; these propensities vary from sector to sector and from time to time. Financial and operating conditions, such as profitability, business confidence and the current and projected levels of capacity utilization, combine with changes in the economy-wide cost of capital and other factors to produce the complex lag relationship between demand on machine tool buyers and demand on machine tool builders. Fluctuations in demand and industry shipments have often been abrupt, as Figures 1, 2 and 3 show.

The economic behavior of machine tool producers has been fundamentally affected by the cyclicality of their industry. Because of such cycles, the industry has tended not to invest in new capacity until the long-term need for such capacity becomes reasonably well established. To do otherwise would be to invest capital that would be unproductive during downturns in the industry's cycles and hence would produce, over the entire cycle, an inadequate return on investment. The industry has also sought to buffer its cycles by accumulating new orders during periods of strong demand and filling such orders during periods of slack demand. This policy minimizes layoffs of the skilled workers on which the industry depends and rationalizes production schedules. The result, however, has been that increases in new orders have been accompanied by lengthening lead times.

Among other results, the industry's cycles have: (1) made a high debt-equity ratio imprudent, if not impossible, in light of the attitude of lending institutions toward debt-service coverage during downturns in the business cycle, (2) required the industry to offset losses during bad years by achieving or attempting to achieve compensatory profits during good years, and (3) restricted the industry's ability to expand its production rapidly in response to increases in new orders.

The relatively small size of the companies comprising the United States machine tool industry and the constraints that its cyclicality imposes on their financing and operation have made this industry, and the enormous American market that it primarily serves, vulnerable to targeting by foreign governments. These governments have recognized, and have exploited, the competitive advantages that can be attained in this market by subsidized and governmentally-organized foreign companies.

III. THE CONDITION OF THE U.S. MACHINE TOOL INDUSTRY REMAINS DEPRESSED AND IMPERILED

The United States machine tool industry is severely depressed. Current data on orders, shipments, employment, profits, capital formation and capacity utilization all point to the conclusion that the industry is experiencing unprecedented strains -- strains that cannot safely be assumed to be a result of the business cycle.

Because a number of news stories have reported increased orders for machine tools in recent months, some have interpreted these reports as an indication that the machine tool industry has begun a significant recovery and that its economic woes will soon be over.

Unfortunately, this is clearly not the case. While orders have increased moderately from last year's levels, those 1982 levels were so extraordinarily low that even a modest increase looks big on a percentage basis. When expressed in real, inflation-adjusted dollars, however, the industry's economic position today can be shown to be more precarious than it was a year ago.

More importantly, even as the total machine tool market has declined over the past three years, the market share of imported machine tools continues to skyrocket. Hence, even with the current modest increase in machine tool orders, an increasingly large percentage is going to foreign manufacturers.

If anything, the most recently available data support even more strongly the industry's contention that a curb on imports is urgently needed to assure the continued viability of a domestic machine tool industry capable of meeting our national security needs.

A. New Orders

When the industry's section 232 petition was filed in March 1983, its net new orders were at their lowest level in over a decade in nominal dollars. Far more important, however, in real, inflation-adjusted dollars, orders had fallen to their lowest levels since the recession of the late 1940's.

It is from this 35 year low point that a small increase has taken place.

Using 1972 constant dollars, the value of net new machine tool orders for the first three quarters of 1983 (latest data) are as follows: $99.5 million; $124.9 million; and $146.6 million, for a total of $371.0 million. Real orders for the same period in 1982 stood at $376.2 million, leaving 1983 $5.2 million behind the 1982 totals. While quarterly order levels have strengthened throughout 1983, the industry is clearly far from substantial recovery.

In contrast to the "improved" quarterly averages of 1983, consider the levels of quarterly average real orders in the past few years:

1978	$554.1 million
1979	623.6 million
1980	450.8 million
1981	253.2 million
1982	120.3 million
1983	123.7 million (first three quarters)

Even at the depth of the previous machine tool order recession in 1975, quarterly average orders were almost $215 million, with the worst quarter during that decline being $163.9 million. In other words, to date, the very best quarter of 1983 was still below the very worst quarter of the industry's previous recession! This can hardly be classified as an industry recovery.

B. Shipments

Even worse, since the cash flow of the industry is tied to shipments--not orders--the revenues from even the modest 1983 increases in orders will not reach machine tool companies for some time. In fact, shipments in the latest reported quarter (third quarter 1983) stand at the lowest level in real dollars since the end of World War II.

In my own company's case, while shipments began to decline in 1982, we were most severely impacted during 1983 when shipments dropped 56.4 percent from the previous year's total. This closely parallels the industry's decline of 57.4 percent during the same period.

The 1982 level, again in real inflation-adjusted dollars, was $972.4 million. The 1983 level is $414.1 million. Since the builders do not receive their money until the machine is shipped, the actual amount of cash coming into the industry today is at an all time low.

C. Employment

Although the industry has been able to rehire a few employees in 1983, we have hardly been able to make a dent. From April of 1980 to July of 1983, employment in the domestic industry plummetted from 110,200 workers to 64,600. This is an average job loss rate of over 1100 persons per month for 40 months. By October of 1983, the industry had rehired only 1400 of these laid-off workers. While orders have shown signs of improvement throughout 1983, in the course of the three months following the industry's employment trough we were only able to rehire 3 percent of the work force that had been laid off during the industry's long downturn.

Figure 4 breaks out separately the industry's total employment of "production workers" annually for the years 1972 through 1979 and monthly for the years 1980 through 1982.

This category, which excludes employees engaged in sales, service and administrative occupations, includes the skilled machinists and other production employees whose training and experience are essential to any mobilization effort. Employment of those workers has fallen 46.2 percent from a peak of 73,700 in April of 1980 to 39,600 as of December 1982, and fell further to 36,600 by July of 1983 when the trough in the industry's employment levels occurred in mid-1983.

The decline in employment of production workers is proportionately greater then the decline in overall employment and has reached into the ranks of workers with relatively high levels of seniority and competence. Industry management is deeply concerned about the implications of this development for the industry's competitive position. The quality of the industry's products depends to a substantial extent on the competence of its production workers. Skilled production workers who are laid off and then find other jobs will be reluctant to return to a cyclical industry that is seriously threatened by imports. The training of replacement workers typically takes two to four years. In the meantime, production efficiency and product quality are likely to suffer, thereby further eroding the industry's competitive position.

Nor does the foregoing employment data fully reflect the depressed state of the domestic machine tool industry. Many workers who remain on the payroll are working short weeks; seven-hour days and four-day weeks, for example, are common.

As I mentioned earlier, in my own company's case, we are down to only 40% of the workforce we employed only two short years ago. And among that 40 % we have implemented a system of four-day work weeks for some, and a one week in four furlough schedule for others.

D. Capacity Utilization

The operating rate of capacity utilization rate measures "[t]he ratio of physical output to physical capacity."[1] Figure 5 records the operating rate for the nonelectrical machinery industry annually for the period 1972 through 1979 and monthly for the years 1980 through 1982 as reported in the long-standing McGraw-Hill surveys.[2] As Figure 5 shows, capacity utilization as of December 1982 was 62.2 percent, its lowest point in the history of the index.[3]

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[1] The McGraw-Hill Dictionary of Modern Economics (2d ed. D. Greenwald 1973), p. 412.

[2] McGraw-Hill Publishing Company, Department of Economics, "McGraw-Hill Operating Rates Report" (monthly).

[3] In January 1983 the McGraw-Hill index dropped to a new all-time low of 62.1 percent.

Understandably, numerous plants have been or are being closed, resulting in a permanent loss of production capacity. In the Cleveland area, for example, among major machine tool builders both Acme-Cleveland Corporation and Warner & Swasey Company (a subsidiary of Bendix) have recently closed plants and offered them for sale. Among other publicly-held companies, Ex-Cell-O Corporation and Cross & Trecker Corporation, both based in Detroit, have recently announced plant closings.

The nonelectrical machinery industry encompassed by the McGraw-Hill report is broader than the machine tool industry, but its operating rates are considered to be fairly representative of those experienced by the machine tool industry over a full business cycle.

E. Industry Profits

Figure 6 shows the industry's pre-tax profits as a percentage of sales for the years 1972 through 1982.

Figure 7 shows for the years 1972 through 1982 the industry's pre-tax profits expressed as a return on gross assets. Figures 6 and 7 document the fluctuations in the industry's profits and the sharp drop in those profits in 1982. The profit outlook for 1983 is even worse.

The risks of investing in the machine tool business are reflected by the uncertainty of the industry's earnings performance over the years. Even under normal conditions, earnings fluctuations in this industry are greater than those experienced by manufacturing industries generally. With imports now holding a large and increasing share of the market, the risks of investing in the machine tool industry are accentuated. Unless the projected returns on investment are high enough to compensate for those risks, managers cannot justify decisions to reinvest. Conglomerate parent corporations engaged in other lines of business will invest their capital elsewhere.

F. Capital Investment

Not surprisingly, in view of the substantial decline in new orders, shipments and profits, the industry's constant dollar net capital investment fell off perceptibly in 1982. As shown in Figures 8 and 9, the industry's net new investment in 1982 was inadequate even to cover the depreciation of existing plant and equipment, resulting in a decline in net plant and equipment on hand.

G. Research and Development

Figure 10 shows the industry's aggregate expenditures for research and development for the years 1972 through 1981.

Figure 10 illustrates that the industry has held fairly steady through 1981 in its research and development expenditures. In the circumstances now facing the industry, however, it is far from clear that this trend will continue. Clearly, any significant decline in -- indeed, any failure to increase -- R & D expenditures would have ominous implications regarding the industry's future competitiveness.

H. Industry Outlook

Only recently have new orders indicated that the U.S. machine tool industry is gradually emerging[4] from the nadir of its worst recession in decades.[5] Even so, "machinery orders are far from buoyant."[6] The continuing gravity of the industry's condition has been recognized by Eli S. Lustgarten, Vice President of Paine Webber Mitchell Hutchins and a respected securities analyst of the machine tool industry. In recent congressional testimony, Mr. Lustgarten noted that during the first half of 1983, orders continued "at about the same low level of demand as 1982 . . . declining new orders and a sharp increase in the cancellation rate resulted in an 82% decline in the industry backlog to $950 million at the end of the second quarter of 1983 from the peak level in excess of $5.5 billion at the turn of the decade."[7]

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[4] In July 1983, new orders for machine tools were "63 percent higher than the extremely depressed $106.6 million of a year earlier." The Wall Street Journal, August 29, 1983, p. 4. In June 1983, new orders rose 15.4 percent above the low level of new orders in June 1982. The Wall Street Journal, July 25, 1983, p. 4. In May 1983, new orders were 28 percent above the year-earlier level. American Metal Market, June 27, 1983, p. 4. In April 1983, new orders were 21 percent below the year-earlier level. The Wall Street Journal, May 31, 1983, p. 6.

[5] For example, as of November 25, 1983, Acme-Cleveland has had five consecutive quarterly losses and is expecting a sixth; through Sept. 30, Brown & Sharp has had seven consecutive quarterly losses and is expecting losses in the last quarter of 1983 as well as the first quarter of 1984; Cincinnati Milacron has had five consecutive quarterly losses, expects a sixth, and will break even in the first quarter of 1984; and Gleason Works has had seven consecutive losses, expects another quarterly loss in the fourth quarter of 1983, and to break even in the first quarter of 1984. Value Line (Machine Tools), November 25, 1983, p. 1344. In their annual reports for 1982, Textron (Annual Report, p. 40), White Consolidated Industries (Annual Report, p. 9) and Lodge & Shipley (Annual Report, p. 4) reported losses on the 1982 operations of their machine tool segments. This trend is unlikely to have abated in the interim, because "shipments of machine tools in July (1983) fell to the lowest levels in more than ten years. . . .," The Wall Street Journal, August 29, 1983, p. 4, and machine tool builders receive payment upon shipment.

[6] The Wall Street Journal, August 29, 1983, p. 4.

It is probable that a substantial upturn in this capital goods industry will not occur until 1984[8] and that 1983 was a year of continued substantial losses for most U.S. machine tool companies. Mr. Lustgarten recently observed that "[t]he bottom line [for the U.S. machine tool industry] is that machine tool manufacturers will lose money in 1983 and perhaps through the first half of 1984 with plant closings, layoffs and severe price discounting commonplace."[9] He added that "[t]he current decline in machine tool demand is likely to be one of the sharpest and longest corrections of the post WW II era."[10]

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[7] Statement by Eli S. Lustgarten before the Subcomm. on Economic Stabilization of House Comm. on Banking, Finance and Urban Affairs, July 26, 1983, p. 1 (hereafter Statement by Eli S. Lustgarten, July 26, 1983). Elsewhere, Mr. Lustgarten has stated his view that "the recent buoyant action of machine tool stocks is based on wishful thinking." New York Times, June 8, 1983, p. D-10.

[8] The Wall Street Journal has reported:

> Chief White House economist Feldstein warns that high interest rates and the strong dollar will crimp some industries and keep the recovery uneven. Exporters face persistent trouble selling abroad. Interest rates will continue to curb construction and sales of much business equipment. One analyst sees no significant gain in capital spending for six to nine months." Id., July 15, 1983, p. 1.

The Washington Post recently reported that, while new orders for machine tools in June 1983 were up nearly 50 percent from the level in January 1983, many "customers are either postponing delivery on existing orders or writing new orders with unusually long-term delivery schedules, apparently to avoid paying for the machinery until interest rates drop and cash flow improves and until demand for their products picks up and makes the new manufacturing equipment necessary." Id., August 25, 1983, p. C3. The article observes that "machine tools are not paid for until they are delivered" and that "[s]imply placing an order costs virtually nothing." Id. the Conference Board recently reported that its survey of business executives shows that, while "[b]usiness confidence in the second quarter [of 1983] soared to its highest level in the seven-year history of [the] survey . . ., 72 percent of the respondents did not revise their capital spending plans and 11 percent actually lowered them. . . ." American Metal Market, July 18, 1983, p. 15.

During this depression in the industry, a formidable expansion of the share of U.S. machine tool consumption attributable to imports, particularly those from Japan, continued. In 1983 in the United States, consumption of machine tools declined by 45 percent, this following a 23 percent decline in 1982. However, during this time total consumption of import machine tools declined only 9 percent in 1982 and by a further 23 percent in 1983[11] Not only did imports fare relatively well in the U.S. market, but, the total business of key foreign producers fared significantly better than the business of U.S. producers in the current world machine tool recession. While the U.S. suffered a decline in total shipments of 29 percent in 1982 and 45 percent in 1983, Japanese production declined by 9 percent in 1982 and by only 7 percent in 1983. West German production declined by only 19 percent over the two years.[12]

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[9] Statement by Eli S. Lustgarten, July 26, 1983, p.2.

[10] Id.

[11] American Machinist, February 1984, p. 77.

[12] American Machinist, February 1984, p. 77.

Now that the lead times of American machine tool producers are short,[13] Japanese producers are pursuing what appears to be a relentless campaign to increase their already significant share of the U.S. machine tool market by offering, on a regular basis, deep discounts below their list prices and extremely generous financing terms. In recent testimony before the International Trade Commission, the chairman of Acme-Cleveland Corporation stated that "[a] representative example is provided in a letter that the president of Lodge & Shipley recently sent to the Commission, which describes a recent sale by the Japanese Yamazaki Machine Tool Company at a 28 percent discount off list price, with a six-month cost-free trial period and then 10 percent down and five years to pay with 4 percent interest."[14]

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[13] In April 1981, the order backlog of the U.S. machine tool industry was approximately $5 billion. In April 1983, it was $989 million. New York Times, June 8, 1983, p. D-10. It was recently reported that "[d]efense contractors note there is up to a one-third improvement in the delivery times by domestic machine tool makers." American Metal Market, August. 22, 1983, p. 20. The director of plant engineering at McDonnell Aircraft Company, Tulsa, stated that "the delivery time from U.S. machine tool manufacturers has improved considerably. In some cases it's down to six months. The machine tool builders have been able to meet the delivery schedule quoted to us.'" Id. A spokesman for the fabrication division of the Boeing Company, Seattle, stated that "'there is much better delivery and availability from U.S. machine tool builders, who are on schedule with no delivery problems.'" Id.

[14] Testimony of W. Paul Cooper before the International Trade Commission, June 28, 1983, p. 7. The ITC's recent survey of purchasers of machine tools indicates that as "the reason for purchasing foreign-made machine tools, price was ranked number one." Statement of Commissioner Haggart, Transcript of Proceedings, Hearings in re Competitive Assessment of the U.S. Metalworking Machine Tool Industry (No. 332-149), International Trade Comm'n, June 28, 1983

(footnote cont'd.)

IV. THE CURRENT IMPORT TREND PRESENTS A VERY SERIOUS THREAT TO THE U.S. MACHINE TOOL INDUSTRY'S SHORT-TERM SURVIVAL AND LONG-TERM HEALTH

NMTBA's Petition was not prompted by a temporary glut of imports. Instead, it confronts an aggressive, abrupt thrust, primarily by Japanese manufacturers, aimed at domination of the U.S. and foreign markets for NC machine tools, which are not merely a niche but instead are, and for the foreseeable future will continue to be, the heart of the U.S. machine tool market. This thrust began in 1978-81, when Japan exploited, with prompt deliveries of import machine tools, the long backlogs of U.S. builders, which were swamped by an unusual and largely unanticipatable short-term acceleration of demand. Today, the Japanese thrust is powered by the extreme price discounting and unmatchable financing terms described above.

Foreign domination of the NC machine tool market is likely to have serious long-term consequences for the health of the U.S. industry, because NC machine tools are in the course of establishing a predominance in the U.S. market, now in the stand-alone machine tool market -- in which NC machine tools represented over 36 percent

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(hereafter "June 28 ITC Hearings"), p. 62. Recently, the Japan Economic Institute of America, a registered agent of the Japanese Government, took the position that "Japanese builders of numerically controlled lathes and machining centers . . . were no more successful in generating new business than their American counterparts, despite the availability of deep discounts, creative financing deals, and other generous sales incentives." JEI Report No. 21A (June 3, 1983), pp. 2-3 (emphasis added). "[P]rice cutting [in the machine tool industry] has been devastating . . . [and] rampant." New York Times, June 8, 1983, p. D-10.

of consumption in 1982[15] -- and in the future as the core of flexible manufacturing cells and systems.

The market for NC machine tools today consists almost exclusively of "stand-alone" machines that are not part of an integrated system. When capacity utilization rises in the companies that are the machine tool industry's customers, however, it is probable that many companies will begin to replace older machine tool layouts with state-of-the-art flexible manufacturing cells or systems, in which computer-integrated NC machine tools are the most important component. A flexible manufacturing system also includes controls, computer software, materials handling systems and, in some applications, robots. Together these ancillary elements account for a substantial part, perhaps a majority, of the value added to the FMS. Without its core of integrated NC machine tools, however, an FMS is worthless because it cannot perform the cutting and forming operations for which it is installed.

The advantages of FMS -- greater productivity through automation and the flexibility to adapt to market changes that come from the ability to make smaller batches economically -- give rise to predictions that the market for FMS will grow from a small figure today to as much as $1 billion by 1990.[16] This anticipated growth involves the bright hope of new business but also a future challenge to the industry's stability, because a significant part of the growth of the FMS market will occur at the expense of the existing market for non-flexible automation -- *i.e.*, dedicated, high-volume transfer line machine tool assemblies -- which have remained almost unaffected by imports. It is essential to the long-term health of the U.S. machine tool industry that it secure a major participation in the supply of NC machine tools and ancillary equipment, software and services that will be demanded by the incipient FMS market.

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[15] Testimony of W. Paul Cooper before the International Trade Commission, June 28, 1983, p. 3.

[16] Id., p. 9.

United States machine tool builders remain the technological and sales leaders in the infant FMS market. In very few instances do U.S. machine tools presently lag behind the technology of foreign producers. Such technology lags, where they occur, are limited to highly specialized equipment.

The Japanese Ministry of International Trade and Industry, for example, recently acknowledged that their best machining centers are technologically inferior to the best machining centers made by U.S. builders, even though in 1982 Japanese machining centers accounted for 37 percent of U.S. consumption as measured by value and 63 percent as measured by units. According to MITI's report, the product technology level of Japanese machining centers is substantially inferior to that of American machining centers because the Japanese are "considerably behind the U.S. . . . in spindle speeds, maximum allowable torque, main motor output and cutting efficiency."[17] The report adds that "[i]n precision machinery technology, . . . Japan is behind the U.S. and West Germany" and that "Japan is also behind the U.S. in design technology, where the U.S. is pouring effort into CAD/CAM."[18] MITI also concluded that Japan is inferior to the United States with respect to the production of package software.

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[17] *Metalworking Engineering and Marketing*, May 1983, p. 82

In addition, American FMS technology is unexcelled. "At the end of 1981, there were only 25 truly flexible systems operating in the world, (two thirds of which were in the U.S.)."[19] Hughes Aircraft Company recently put in operation an FMS built in the U.S. by Cross & Trecker for the production of aircraft and missile parts. "[M]anagement mandated that the most modern, state-of-the-art equipment would be provided," and although "Hughes has no 'buy-American' policy, . . . all bidders were U.S. firms."[20] More recently, the Watervliet Arsenal awarded a $15.3 million contract to the Manufacturing Systems Division of White Consolidated Industries for installation of a state-of-the-art FMS.[21] Representatives of the U.S. machine tool industry have strenuously affirmed the preeminence of U.S. builders in FMS technology and NC machine tools generally.[22]

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[18] Id.

[19] Statement by Eli S. Lustgarten, July 26, 1983, p. 15.

[20] American Machinist, May 1983, pp. 109-11.

[21] American Metal Market, August 22, 1983, p. 17

[22] Testimony of Richard T. Lindgren, President and Chief Executive Officer, Cross & Trecker Corporation, before the International Trade Commission, June 28, 1983, p. 2.

But there is a real danger that, as with NC stand-alone machine tools -- whose technology the U.S. industry invented and commercialized -- the FMS market may be lost to low-priced foreign competition. If foreign imports succeed in the short-term in establishing a dominant position in the U.S. market for NC stand-alone machine tools, they will be in an excellent position to take a commanding share of the FMS market. If this happens, major parts of the U.S. machine tool building industry will be gravely and permanently debilitated. Therefore, the recovery of strength in NC stand-alone machine tool markets in the near term is a prerequisite for the industry's long-term health.

The trend that will probably develop in the U.S. machine tool industry if the requested relief is denied has already appeared in tentative but unmistakable form. That trend is for foreign suppliers, particularly the Japanese, to supply the NC machine tools for the American market, while American companies supply some of the controls, robots, computer software and engineering design services used with the machine tools in FMS and similar applications. In other words, while American firms would supply technical services and some equipment ancillary to machine tools, the core of the factory automation systems -- the NC machine tools -- would come predominantly from abroad. If this trend is realized, it will result in a very major displacement of U.S. machine tool manufacturing capacity.

The very early stages of this trend are indicated by Bendix's[23] announcements last year that it would close or sell seven of its U.S. machine tool plants,[24] including a new plant in Nashville, Tennessee,[25] and is transferring production of all of its lathe parts and its NC chuckers, including its newest turning machine, to Japanese factories.[26] At the same time, pursuant to an agreement with Toyoda Machine Works, Ltd., Bendix will sell Japanese-made machining centers in the United States under the name "Bendix-Toyoda."[27] Similarly, the National Acme division of Acme-Cleveland Corporation recently announced that the state-of-the-art NC chucking machine that it developed jointly with Mitsubishi Heavy Industries, Ltd., will be produced in Japan for the indefinite future, although the machines will bear the National Acme label and Acme-Cleveland will retain the option to produce the machines in the U.S. The New Britain Machine Division of Litton Industries, Inc., will market in the U.S. numerically controlled vertical precision lathes produced by Tsugami Corporation of Japan.[28] Cross & Trecker, which has closed and put up for sale its new and advanced machine tool manufacturing plant at Port Huron, Michigan, and its Fraser, Michigan, machining plant, is currently exploring the possibility of obtaining major components from Japan.[29]

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[23] Bendix's machine tool division was sold to Cross & Trecker in February, 1984 for a reported $65 million -- about one fourth of the price paid by Bendix for Warner & Swasey only four years ago. Prior to Bendix's acquisition of Warner & Swasey in late 1979, it already owned substantial machine tool producing capacity.

[24] Detroit Free Press, June 23, 1983, p. 8B.

[25] American Machinist, Jan. 1983, p. 43.

[26] Id.; American Metal Market, July 18, 1983, pp. 1, 18.

[27] American Machinist, Jan. 1983, p. 43.

Nathaniel S. Howe, former Chairman of NMTBA stated that, with respect to the developing trend toward American companies' shifting of production facilities to overseas sites:

> "[M]any of the . . . machine tool companies in this country have, in effect, developed what I call standby plans. They are waiting to see what's going to happen, We are not going to perish and if it becomes a requirement to go overseas to get the manufacturing done, that's very likely what's going to happen. But I would say basically that there are many companies who wish to remain here and continue their manufacturing here if conditions permit."[30]

If, however, the trend toward foreign sourcing continues, domestic machine tool manufacturing capacity will fall rapidly.

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[28] Japan Economic Institute, Japan Report, No. 162, Mar. 18, 1983, p. 4.

[29] American Metal Market, June 27, 1983, p. 14. Accord, Testimony of Richard T. Lindgren, President and Chief Executive Officer of Cross & Trecker Corp., June 28 ITC Hearings at 34, 39.

[30] Id. at 39-40.

V. THE U.S. MACHINE TOOL INDUSTRY HAS UNDERTAKEN SUBSTANTIAL INITIATIVES TO HELP ITSELF

Notwithstanding currently discouraging economic circumstances, the U.S. machine tool industry has mounted a vigorous campaign of self-help. As even JMTBA acknowledged last year, the U.S. machine tool industry is "[l]earning its lesson from past downturns and from the stiff competition provided by foreign manufacturers."[31] The relief that NMTBA requests would complement the industry's self-help initiatives by giving those initiatives time to take hold and produce results.

The description of U.S. machine tool companies' self-help initiatives that follows draws upon annual reports of publicly traded machine tool companies, personal interviews with executives of certain of the larger machine tool manufacturers, testimony of machine tool executives before the International Trade Commission on June 28, 1983, and letters from executives of 26 machine tool companies that represent a cross-section of the U.S. industry and its approaches to self-help.

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[31] Comments of Japan Machine Tool Builders' Association to the International Trade Commission, Competitive Assessment of the U.S. Metalworking Machine Tool Industry (No. 332-149), p. 38 (Feb. 3, 1983).

The goal of the self-help initiatives is an industry that will be fully competitive in world markets. As representatives of the U.S. industry forthrightly acknowledged in the report of the Japanese study mission published in September 1981,[32] achievement of this goal requires that U.S. producers must lower unit production costs, increase quality and service and continue technological innovation by:

-- Development of programs to motivate, build trust and instill pride in the U.S. machine tool work force, seeking a more cooperative and less adversarial relationship between labor and management in order to achieve greater productivity.

-- Aggressive investment in innovative production technologies, including automated, unmanned, flexible manufacturing systems (FMSs) sacrificing, where necessary, near-term profit for long-term gain.

-- Sustained strong investment in research and development to devise new products that are durable, productive and efficient, and technologically advanced.

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[32] NMTBA Japanese Study Committee, "Report: Meeting the Japanese Challenge" (1981). The report followed a two-week on-site examination of the technologies, production methods and products of the Japanese industry by leaders of the U.S. industry. The purpose of this study mission was to understand the reasons for Japanese successes.

- -- Emphasis on the quality of U.S. machine tools and responsiveness of U.S. builders to customer needs in the design, manufacture, application and servicing of American machine tools -- paying close attention to changing customer requirements.
- -- Pursuit and cultivation of all feasible opportunities to market American machine tools worldwide.[33]

There is a consensus in the industry that these initiatives must be pursued as a matter of highest priority.

In addition to pursuing these goals, members of the American industry have made painful economic choices in face of the current recession, closing older plants and permanently reducing employment. Depending upon the amount of investment in modern production equipment that follows, these actions are the harbinger of either a highly productive and competitive domestic machine tool building industry, or one that is severely diminished.

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[33] Significantly, the report did not recommend import controls against foreign competition. However, in a comment appended to the Commission's Report, Nathaniel S. Howe, the Missions's Chairman, stated that if foreign competition were seriously to affect the health of the domestic tool building industry, it would then need to seek temporary help from the United States government on national security grounds. "Meeting the Japanese Challenge" a report prepared by the Japanese Study Mission of the NMTBA, p. 8 (Sept. 14, 1981).

A. Human Capital -- Labor Relations

Machine tool builders are trying to improve productivity through better motivation and training of employees. Some companies have instituted profit sharing programs and/or employee stock ownership plans to give their workers a direct stake in the companies' prospects. Other have emphasized improved training programs. Examples of such training programs include: (i) providing an opportunity for all workers to be trained in the use and programming of CNC equipment -- even if not required by their current jobs; (ii) increasing employee skill levels through use of "work centers," in which employees work together as a team, learning to operate all machines in the particular work center; (iii) reimbursing employees for the costs of any training or schooling completed outside the plant; and (iv) employing full time training managers to design and administer apprenticeship programs to allow upgrading of employee skills.

Many companies have instituted routine labor-management meetings. At such meetings, management briefs employees regarding capital spending plans, the financial condition of the company and the financial outlook. Candid discussions of this sort have been especially important during the current extreme recession. These meetings provide an opportunity for employees to discuss work-related problems and to question top management regarding a company's plans and prospects.

B. Capital Investment and Productivity

American machine tool builders realize the further modernization and automation of production facilities are required if they are to remain competitive. This realization is not belated; during the period 1976-1981, capital investment in the machine tool industry grew at twice the rate for all other manufacturing in the United States.[34] Although this rate of investment has been affected by the current deep recession in the industry, investment continues in the most sophisticated equipment such as flexible manufacturing systems and CAD/CAM.[35]

According to its 1982 annual report, Cincinnati Milacron spent $26.7 million to modernize its facilities through installation of flexible manufacturing systems and CAD/CAM. Additionally, the company budgeted $12.5 million to continue this modernization during 1983.

According to its 1982 annual report, the Monarch Machine Tool Company spent $4.0 million to add to its capacity in Sidney, Ohio, to build CNC vertical turning machines.[36] Another company is planning a $2.8 million technology center. According to B. Charles Ames, President and Chief Executive Office of Acme-Cleveland Corporation, speaking at a December 1982 machine tool forum sponsored by Paine Webber, that company is constructing two new plants as a part of a $6.4 million program to increase productivity.

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[34] Testimony of Nathaniel S. Howe before the International Trade Commission, June 28, 1983, p. 4.

[35] *Id.*

[36] Monarch 1982 Annual Report, p. 16.

Many companies continue to invest in new machines, albeit at a reduced rate, in order to improve productivity, to increase the quality of their products and to shorten delivery times.

The Ingersoll Milling Machine Company recently received an award from the Society of Mechanical Engineers for its leading role in developing and installing computer-integrated manufacturing in its Rockford, Illinois plant.[37]

C. Research and Product Development

Given the rapid advances in technology that are affecting the industry and its customers, expenditures for research and development are the lifeblood of the machine tool business. To compete effectively in the domestic and export markets, the industry must retain the ability and the incentive to continue and increase its R&D expenditures. If the industry's sales and profits continue to decline, however, this will become impossible. The result will be a vicious circle in which declines in sales and profits will retard technological advances, causing further declines in sales and profits, with the cycle continuing until the industry has fallen irretrievably behind its foreign competitors. The risk that the domestic machine tool industry may thus be eclipsed by its foreign competition -- as other once-strong United States industries already have been -- has obvious importance for the national security.

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[37] Commline, the Journal of Computerized Manufacturing, May-June 1983, pp. 10-11. In addition, NMTBA has promoted, among its members, investment in and installation of manufacturing process improvements. For example, it recently sponsored a conference on "Manufacturing Management in Today's Economy" involving discussion of topics such as the use of flexible manufacturing systems, the potential of robotics for machine tool manufacturing, the rise of computer aided design and the costs and benefits of achieving better quality control.

Many companies have continued significant research and development expenditures, notwithstanding severe economic stringency. According to Laura Conigliaro, machine tool analyst for Prudential-Bache Securities, "a number of manufacturers have increased their research and product development budgets, despite slack sales and revenues, in order to be prepared for a rebound."[38]

Cincinnati Milacron has recently completed a $6.8 million research center at its Cincinnati headquarters.[39] Similarly, Ex-Cell-O Corporation has established a new technology center for machine tool research and development.[40] The Monarch Machine Tool Company is adding a new engineering development laboratory to its Sidney, Ohio facility,[41] and South Bend Lathe, Inc., has recently established an engineering group in its research division dedicated exclusively to product innovation.[42]

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[38] American Metal Market, June 13, 1983 at p. 9A (emphasis added).

[39] See Cincinnati Milacron 1981 Annual Report, p. 29.

[40] Ex-Cell-O 1982 Annual Report, p. 5.

[41] Monarch 1982 Annual Report, p. 21.

The results of commitments to R & D have been continued new product introductions during the recent and continuing machine tool recession. In addition, work is ongoing on product lines that will be introduced in the future. Cross & Trecker, for example, plans to introduce in 1984 a new generation of flexible manufacturing systems that will significantly advance the state-of-the-art.[43]

Notwithstanding allegations to the contrary, American machine tool producers are retaining a technolcgical lead.[44] In the important growth field of flexible manufacturing systems (FMS), Americans' technological capabilities in machine tool manufacturing, component hardware and software and robotics, place American manufacturers in a good position for potential success. American computer numerically control (CNC) machine tools and technology are equal to or better than those made in Japan.[45]

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[42] Personal communication to Covington & Burling from J.R. Boulis, President of South Bend Lathe, Inc.

[43] Testimony of Richard T. Lindgren before the International Trade Commission, June 25, 1983, p. 3.

[44] Testimony of Richard T. Lindgren before the International Trade Commission on June 28, 1983, pp. 2-3.

[45] Id., p. 6.

D. Responsiveness to Customers

American machine tool builders have substantially increased their responsiveness to customers. Several companies have conducted extensive efforts to determine what innovations and adaptations will be needed to meet the needs of customers in the future. For example, Cross & Trecker Corporation has invested much of its engineering staff's time in learning the specifications of the machine tools and manufacturing systems that its customer industries anticipate requiring in the next decade and beyond.[46] Similar customer surveys allow companies with inventories to alter inventory levels on the basis of better market data.

American companies have improved their delivery of spare parts to reduce the downtime of their machine tools on customer premises. Some companies have installed computer systems to handle spare parts orders and now can ship spare parts within 24 hours of client orders. Similarly, some companies have built diagnostic systems into their machine tools that permit immediate telephonic communication of the source of the malfunction from the machine to the companies' engineering staffs.

Many companies now run regular customer training schools on programming and maintenance of the machine tools that they produce. Cross & Trecker has developed detailed seminars for customers on the advantages of flexible manufacturing systems, and a team of Cross & Trecker representatives has given such seminars to customer companies.[47] In addition, many companies have established financial subsidiaries that enable their operating units to offer both installment and lease financing at highly competitive rates.[48]

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[46] Testimony of Richard T. Lindgren before the International Trade Commission, June 28, 1983, p. 3.

Most companies have increased their efforts at quality control. Suppliers are held to stricter quality standards. The number of quality checks during construction, and the comprehensiveness of checks during the testing of completed machines, have been increased. Some companies offer incentive to employees for meeting quality goals. Some have programs to follow the performance of a machine tool after it has been installed on a customer's premises.

All companies recognize that lead times must be kept reasonably short, and much shorter than they became in 1980-81. To that end, some companies have begun to produce machine tools for inventory.

E. Aggressive Domestic Marketing

Increasingly, companies are making heavy commitments of their engineers' and other employees' time to explain the vast potential of modern machine tools, especially in FMS applications for each customer's specific needs. Because FMS requires a dramatically new approach to manufacturing operations, this is nothing less than a serious effort at proselytizing the companies that account for much of the United States' industrial base, in an effort to persuade them of the net benefit of investing in highly productive and flexible applications of modern machine tools. In the past year, the senior executives of a significant number of machine tool companies have undertaken this effort, in the hope that it will produce new orders at the end of the recession.

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[47] Id. at 6.

[48] Id. at 7.

So that both their sales and service staffs will be closer to customers, some of the larger U.S. machine tool companies that do not sell through distributors are opening large regional centers in major metropolitan areas. Cincinnati Milacron, for example, will open its fifth regional sales and service center this year.

F. Export Promotion

In light of the current levels of import penetration in American machine tool markets, expanding exports of American-manufactured machine tools is more important than ever. Moreover, the February 1983 report of the Machine Tool Panel of the National Academy of Engineering regarding the machine tool industry recommends strengthening export performance by the industry. A number of the attached communications from individual companies affirm the industry's recognition of the importance of export efforts. Some have recently employed foreign marketing experts and have exhibited at overseas machine tool shows. Others have signed on additional foreign distributors and have spent significant amounts to educate those distributors about the merits of their products.

The NMTBA emphasizes assistance to its members in securing export market opportunities. It maintains an international trade department; conducts international market research; sponsors expositions on behalf of the industry at foreign machine tool shows; and brings large groups of foreign visitors to the International Machine Tool Show sponsored every two years by NMTBA. Three professional trade specialists employed by the Association spend all their time either traveling overseas to promote United States machine tool products, conducting workshops to train member companies how to deal with the complexities of international trade, or consulting informally with company representatives about foreign business opportunities.

NMTBA collaborates with the Department of Commerce in conducting export seminars to educate United States manufacturers on export opportunities and techniques. The Association recently sponsored a seminar for machine tool industry members regarding the Export Trading Company Act of 1983. In 1982, the Association sponsored the most expansive machine tool show ever held in Mexico and in March 1983, conducted the first formal exposition of American machine tools ever held in the Peoples' Republic of China.[49] Based upon the success of this effort, a second exposition is planned for Shanghai in 1985.

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[49] The vigorous efforts of the NMTBA to assist its members in obtaining export sales are elaborated in the testimony of James A. Gray, President of the NMTBA, before the International Trade Commission on June 28, 1983, at pp. 3-5.

Notwithstanding the high priority accorded to export promotion by the Association and many of its members, there are serious impediments to increasing United States exports that are beyond the control of the industry. As summarized in the recent testimony of Mr. Lustgarten,[50] these impediments include the competitive disadvantage suffered by United States firms because of the strength of the U.S. dollar in relation to foreign currencies and the trend of foreign countries to close their markets to U.S. builders through various nontariff policies. As reported by Mr. Lustgarten, "[n]ationalization and/or consolidation efforts are underway in France, Spain, U.K. and several other European countries, effectively closing the markets to U.S. builders."[51]

Moreover, a major potential market, Eastern Europe and Russia, has been effectively closed to U.S. builders by stringent and sometimes capricious export control policies of the United States. Records of the Department of Commerce show that in 1982, the Soviet Union imported $960 million worth of machine tools.[52] Of this amount, only $1.3 million worth -- comprising 12 machines -- was supplied from the United States.

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[50] Statement by Eli S. Lustgarten, July 26, 1983, p. 5.

[51] Id. Specifically, Ingersoll Milling Machine Company has complained of exclusion of American machine tools from French markets.

[52] Department of Commerce, Export Report, Series EM-522 (1982).

Thus, while the desirability of expanding U.S. exports of machine tools remains indisputable, this goal is increasingly difficult to accomplish. Nevertheless, members of the U.S. industry will continue to strive for export sales wherever serious economic and political obstacles can be overcome.

G. Personnel and Facilities Retrenchment

A necessary and difficult part of the industry's efforts to help itself in the last two years has been retrenchment. In order to minimize losses in the current economic climate, many companies have been forced to reduce employment. For instance, Acme-Cleveland's employment has fallen from 6,300 at the end of 1980 to 2,500 at the end of April 1983.[53] As part of their efforts to consolidate operations and to continue automation, Cross & Trecker has reduced employment from 4,600 to 2,600 and the company plans to operate in a less labor-intensive mode once the economy recovers.[54] Gleason Works has recently reduced its workforce from 4,800 to 3,900 and has lowered employee compensation.[55] Other companies, have frozen salaries, reduced fringe benefits, eliminated overtime and shortened work schedules.

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[53] Testimony of W. Paul Cooper before the International Trade Commission on June 28, 1983, p. 5.

[54] Testimony of Richard T. Lindgren before the International Trade Commission, June 28, 1983, p. 5.

[55] Gleason Works 1982 Annual Report.

Similarly, companies have been seeking to improve productivity by closing or attempting to dispose of marginal manufacturing facilities. For example, Ex-Cell-O Corporation has closed or consolidated excess or marginal operations so that the identifiable assets of its industrial equipment segment declined from $258 million in 1980 to $158 million in 1982.[56]

VI. THE U.S. MACHINE TOOL INDUSTRY'S INITIATIVES TO HELP ITSELF ARE NECESSARY BUT NOT SUFFICIENT TO PRESERVE THE INDUSTRY'S STRENGTH

The self-help efforts already underway to reinvigorate the industry offer ample proof that machine tool builders have the will, drive and determination to undertake the steps necessary to restore the health of this critical industry. However, because of the depth of the current recession and the scope of recent import penetration, the industry vitally needs the temporary import relief requested in NMTBA's Section 232 petition. The quota relief requested by NMTBA would strengthen the support of shareholders and capital markets to allow the necessary sustained commitments of capital.

Achievement and maintenance of a strong competitive status in world markets, which is the goal of the self-help initiatives described above, will not be easy. U.S. manufacturers begin with the handicaps of substantially greater overall labor costs, greater costs associated with occupational safety regulations and product liability insurance, high real and nominal domestic interest rates and depreciated foreign currencies that favor imports and discourage exports. Factory automation and more effective marketing nonetheless require substantial investment at the same time that investment in research and development efforts is being increased.

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[56] Ex-Cell-O 1982 Annual Report at pp. 4, 14.

The core of the industry's self-help initiatives is the investment of money. Especially in the circumstance of the continuing recession of the machine tool industry, realizing results from these initiatives will take time and a high level of risk. Results will take time to the extent the industry finances its capital investments with retained earnings.[57]

To counteract the unprecedented threat to its vitality from imports, however, the industry is ready to obtain or commit, to the extent of its ability, substantial resources from sources other than retained earnings for the needed investment, notwithstanding the high level of risk involved. The requested relief would significantly reduce the perceived risk of investment by providing assurance that the juggernaut of foreign imports will be slowed. The relief, combined with the industry's self-help efforts, will also give assurance to the engineers and other employees who are crucial to the U.S. industry's research and development and marketing strategies.

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[57] This is the industry's conventional approach in light of its severe cycles. To do otherwise would increase, in the amount of debt service, the level of sales that a firm must surpass to make a profit, with the result that the firm's financial position might become precarious when deep troughs in the business cycle occur.

It is said by some that the problems of the American machine tool industry are the industry's own doing and that it would be counterproductive to grant the requested relief because such a grant would lead the U.S. industry to complacency and retrogression to old and failed ways. NMTBA emphatically rejects this contention. A grant of the requested relief is a necessary complement of the industry's self-help efforts that will make a very substantial and a very positive difference in the future strength of the U.S. machine tool building industry. The industry realizes that it will need to make the most of every day during the relief period to improve its competitiveness.

Moreover, while the U.S. industry has readily acknowledged that it can improve itself by studying sophisticated contemporary management and production procedures, and with vigor and commitment it has begun to implement applicable changes, the previous absence of those procedures in the U.S. industry is clearly not the only, and is probably not the primary, reason for its current difficulties.

According to the recent study of the machine tool industry by the National Academy of Engineering, "the relatively slow growth in the American economy in recent years cannot be ignored as a major factor governing the condition of the U.S. machine tool industry."[58] Moreover, "Japan, West Germany, France, Italy and the United Kingdom all feature more extensive government participation in the support and direction of their machine tool industries."[59] and many foreign machine tool industries enjoy "aggressive government support . . . to help [them] capture world markets."[60] "[P]roduct liability and safety regulations have a particularly severe impact upon the [U.S.] machine tool industry . . .,"[61] including "dampen[ing] the adoption of new innovations within the machine tool industry and among its customers."[62] Moreover, "government export policy in general has not been particularly helpful in overcoming obstacles to trade."[63] To protect the national security, U.S. machine tool builders have been prohibited from participating in the very large markets for machine tools in communist countries at the same time that Western European and Japanese manufacturers have exported to those markets without significant restrictions. Recently, the relative strength of the U.S. dollar and stringent import controls in financially embarrassed nations such as Mexico have depressed exports, while high interest rates have contributed to the depression of domestic machine tool demand.

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[58] National Academy of Engineering, The Competitive Status of the U.S. Machine Tool Industry, p. 58 (1983).

[59] *Id.* at 27.

[60] *Id.* at 41.

[61] *Id.* at 45.

[62] *Id.* at 71.

[63] *Id.* at 44.

The Japanese Machine Tool Builders' Association has erroneously asserted that the U.S. machine tool industry obtains benefits not available to foreign machine tool builders from "subsidies" granted by the Department of Defense's Manufacturing Technology ("ManTech") Program. Unlike the lavish Japanese programs, which are directed at the development of commercial products for overseas market penetration, ManTech's funds have been taken from military procurement accounts and have been limited to generic research intended to improve methods of producing military weapons systems.

ManTech funds have not been used to assist the U.S. machine tool industry directly since the early 1950's, when approximately $3 million was invested in the development of numerical controls at MIT.[64] Of course, it is hoped that the development projects funded by ManTech will have commercial application, and to that end, it is the Government's policy to disseminate to all members of the public, including foreign machine tool builders, the results of unclassified ManTech projects. However, most ManTech projects involve highly specialized military applications. The advantages to the U.S. machine tool industry from the ManTech program and other military research and development is almost entirely indirect and remote.[65]

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[64] Indeed, ManTech contracts are issued almost exclusively to prime defense contractors. Machine tool builders rarely have that status.

Military-related procurement by the United States and its prime and subordinate contractors exists to meet national security needs, not to prop up the machine tool industry or any other industry. Moreover, the effect of peacetime military procurement on the U.S. machine tool industry is not great. Direct procurement of machine tools by the Department of Defense accounts for only approximately 5 percent of the business of the U.S. industry during peacetime; an additional, approximately 15 percent of the domestic peacetime consumption of machine tools is stimulated by defense contracts. Moreover defense contractors are completely free to use foreign-made machine tools in their plants, and in many cases they do so.[66] Therefore, even if the meaning of "subsidy" were distorted to the point of including U.S. military procurement, such a "subsidy" is equally available to foreign machine tool builders.

The extraordinarily high level of U.S. demand for machine tools in the late 1970's and the resulting large backlogs of U.S.

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[65] The Navy recently committed $425,000 for a three year program primarily to improve robot precision, and some of the money will apparently be spent on a project to improve machine tool precision. American Metal Market, June 20, 1983. This investment, however, is minimal in comparison with the Japanese commitment.

[66] The Buy-America Act, 41 U.S.C. §§ 10a-10d, applies only to direct procurement by the United States and its agencies.

producers, which gave the Japanese a substantial boost in the U.S. market, arose from the effects of oil supply disruptions and the consequent U.S. policies regarding, among other things, automobile and airplane design and domestic oil production.[67] Because these effects were impossible to predict, the U.S. industry cannot be seriously faulted for its inability, in spite of substantial capacity expansions,[68] to meet all of that demand.

There is no doubt that the companies in the U.S. machine tool industry will face strong and healthy competition during the relief period if the relief is granted. In the present circumstances of the industry, unrestricted competition from imports during this period would debilitate, not rejuvenate, the industry. As Professor Paul W. McCracken of the University of Michigan and formerly chairman of the Council of Economic Advisers under President Nixon remarked:

> "[T]here is national security dimension to trade policy. Most of us are programmed to be suspicious of the national security argument. It's often an early argument for protection invoked by domestic industries under pressure from foreign competition. ... If Japanese competitive pressure forces [American industries] to be more aggressive, productive, innovative and quality-conscious, the U.S. civilian and national security needs are both well served. If foreign competition, however, goes beyond this, how far is it prudent for national security reasons to see these industries reduced? ... This is an uncertain and insecure world: national security is indeed a legitimate issue."[69]

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[67] See Testimony of W. Paul Cooper before the International Trade Commission, June 28, 1983, pp. 6-7.

[68] "In the face of rapidly increasing demand, machine tool builders increased capital spending by 57 percent in 1979." *Id.* at 49.

[69] *The Wall Street Journal*, June 25, 1982, p. 18 (emphasis in original in part and supplied in part).

The broad issue is the West's defense against, and the deterrence of, attack by an increasingly formidable and demonstrably expansionist Soviet Bloc -- with which this nation pursues a policy of extremely restricted trade. The specific issue is whether the West can afford the displacement of machine tool production capacity from the relatively secure United States to Japan, which has no serious self-defense capability, or Western Europe, whose machine tool factories and transportation facilities may be isolated as a result of NATO's forward defense of a Western European invasion by the Warsaw Pact.

The National Security Clause is consistent with this nation's faith since World War II that the world's prosperity, and thus world peace, are likely to be strengthened by promoting nations' different comparative advantages through free international trade. Far from being an anomaly, the National Security Clause recognizes the limitations that have always attached to that faith. War can destroy international trade and the prosperity it may bring; and, in maintaining the requisite national capacity to deter war, a nation's primary objective is security and defense, not prosperity. If the United States did not face the threat of war, there would not be justification for the Clause, and if the United States and its allies were not threatened by the massively armed Soviet Union, NMTBA'S Section 232 Petition would not have a basis.

But the threat of war between the Soviet Union and the industrialized democracies exists, and the National Security Clause requires the Government to follow an international trade policy that meets and deters this threat prudently.

VII. CONCLUSION

In conclusion, as the deadline for action by the Secretary of Commerce on NMTBA's 232 Petition approaches (March 14, 1984), questions have been raised regarding the relief requested by the industry. Specifically, some have asked if there are not ways by which the federal government can restore and maintain the health of the domestic machine tool industry without quotas or tariffs. Others have queried as to why not to delay action on the Section 232 Petition to see whether the general economic recovery will cure the problems of the machine tool industry.

Addressing these concerns, I would summarize the rationale by stating that NMTBA has requested quota relief to provide a stable and predictable environment in which the domestic machine tool industry can maintain and increase investment in capital equipment and technology. Such stability and predictability depend crucially on an ability to anticipate import levels and thereby to plan investment during the relief period. Tariffs, for example, in contrast to quotas, cannot provide this kind of predictability. Foreign manufacturers enjoy various forms of subsidization, and their governments may assist them "to jump" any but the most prohibitive tariff barriers the United States might choose to impose. Even if the world were free of such subsidization, the current disequilibrium in exchange rates makes the effect of a tariff at any given level highly uncertain. A further strengthening of the dollar could effectively diminish a tariff. A weakening of the dollar, could, conversely, cause an effective increase of the tariff to a level that was prohibitive and would constrain imports more than quotas.

It is also likely that tariffs would have greater inflationary impact on the United States economy than would quotas. A tariff would affect the prices of all tools imported into the United States; whereas, the quotas we have requested would only affect prices in machine tool lines where imports currently exceed the quota limit. While it is likely that imposition of the quotas we have requested will have some price effect, Data Resources, Inc., (DRI) has estimated that they will not result in a greater than 2 percent increase in the prices of machine tools in any given year during the restraint period. The principal factor that will hold prices down is the robust competition between domestic producers in this highly competitive industry.

During the past year government officials have suggested that, while machine tools are important to the national security, the Administration would prefer to aid the industry by means other than imposition of import restraints. These officials have suggested such steps as increased federal funding for educational programs dealing with manufacturing engineering, increased federal R&D expenditures for machine tool and manufacturing research, streamlining of export licensing procedures, changes to the Internal

Revenue Code to stimulate greater capital investment, better export/import financing, and trade adjustment assistance.

The machine tool industry appreciates this recognition of its importance to the nation's security and it would, of course, welcome all reasonable federal efforts that might help restore and maintain its vigor. Nevertheless, it is apparent that none of these suggested alternative forms of assistance to the industry is an adequate substitute for quantitative restriction of imports.

Nearly all the suggested alternatives would require new budget authority or new tax expenditures at a time of growing national preoccupation with the huge federal deficit. Some would require extensive legislative or rulemaking actions. None would provide timely or comprehensive relief for the badly beleaguered machine tool industry. Individually or in combination these other forms of assistance cannot and would not create the kind of economic environment or degree of predictability that DRI believes is required for new investment in machine tool manufacturing necessary to maintain the nation's security.

Some observers also suggest that, as the recovery continues, machine tool builders will participate, and the need for import relief will be eliminated. Some even contend that machine tool builders are already enjoying the fruits of recovery. We believe our earlier recital of the current economic posture of the industry should dispell any such false ideas.

In light of the continuing severe depression in the industry and the continued growth in market share enjoyed by imports, domestic manufacturers are engaged in a process of closing and dismantling United States machine tool manufacturing facilities. Many will base future economic decisionmaking on the President's decision with respect to the 232 petition. A conscious choice by the President to delay action will add impetus to the current trend of disinvestment by the domestic industry.

The plight of basic industries in America has sparked a dialogue concerning the need for a U.S. "industrial policy." In this regard, considerable attention has been focused on industrial "winners" and "losers" -- one theory being that government policies which encourage the stabilization (and in some cases, expansion) of industries that no longer enjoy a competitive advantage foster an imprudent allocation of resources. Proponents of this theory appear ready to write off many of our basic industries as a "lost cause."

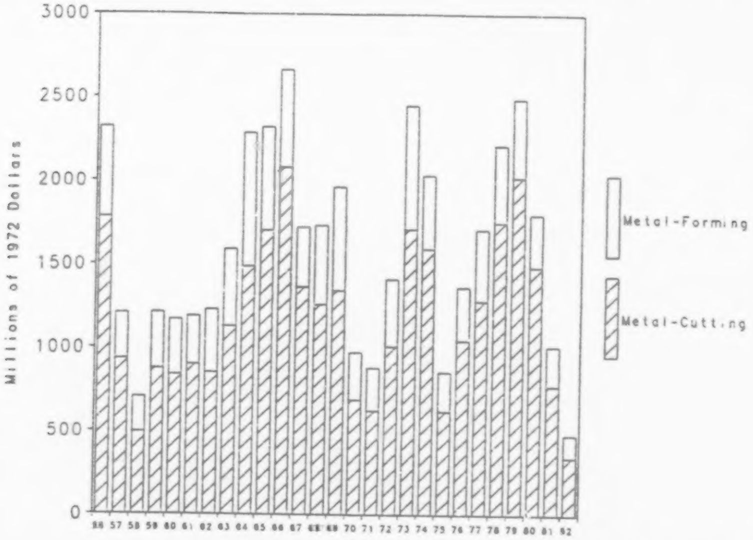
NMTBA views this line of thinking as counterproductive and indeed, dangerous. Basic industries, such as the U.S. machine tool industry historically made up of small entrepreneurs, employ millions of American workers. The presence of industries such as ours provides strength and balance to the U.S. economy; their absence or weakness would lead to a seriously imbalanced economy that would severely limit the chances for sustained economic recovery and growth.

Some have argued that critical goods and materials needed in a time of war can be stockpiled. But production capacity, know-how and readiness cannot be stockpiled. Sophisticated production processes, and sophisticated weapon systems, require a domestic machine tool industry that is at least equal to the world's best. As imports continue to rise, the U.S. machine tool industry -- long the world leader -- is in danger of losing its technological advantage as well as its production capacity. NMTBA submits, therefore, that under Section 232, action must be taken to adjust the level of imports so that the U. S. machine tool industry can regain its competitive edge, thereby reducing the current threat to our national security.

To draw an analogy; there are certain trace elements that are present in the human body which are vital to its sustained good health, resistance to disease and even to life itself. The U.S. machine tool industry can also be considered a trace element, playing an identical role in the economic health of our nation. But most importantly, basic industries such as the machine tool industry play a strategic role in determining this country's ability to respond in the event of a national emergency. Thus, when we talk about the "survival" of this industry, nothing less than our national security is at stake.

Figure 1

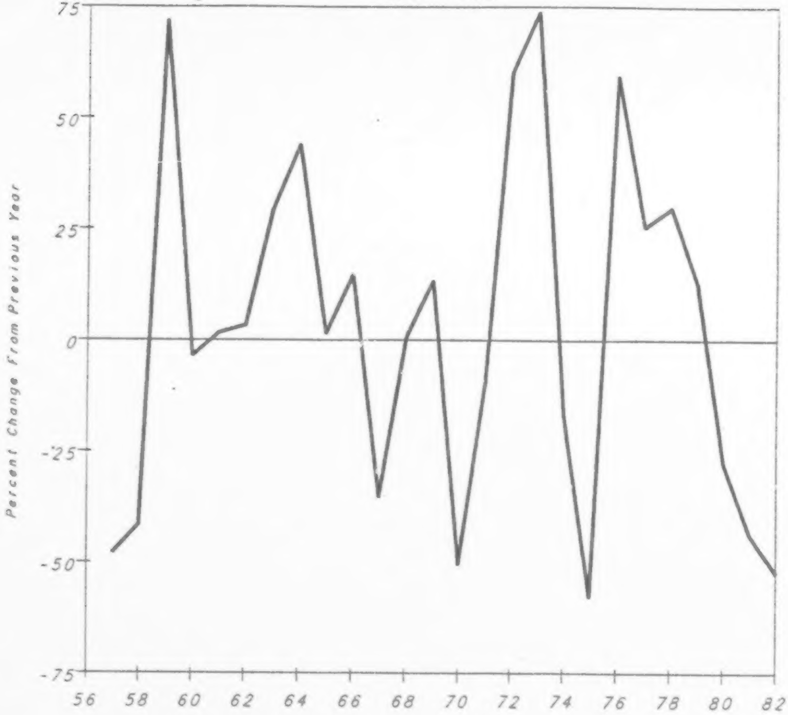
Net New Orders for Machine Tools
Received by U. S. Builders
(1972 Dollars)
1956-82



Source: NMTBA 'Economic Handbook of the Machine Tool Industry, 1982-83' and NMTBA 'Industry Estimate of Machine Tool New Orders, Cancellations, Shipments and Backlog' (monthly).

Adjusted using Bureau of Labor Statistics (BLS), U. S. Department of Labor, Producer Price Index for respective sector, re-based to 1972=1.00.

Figure 2

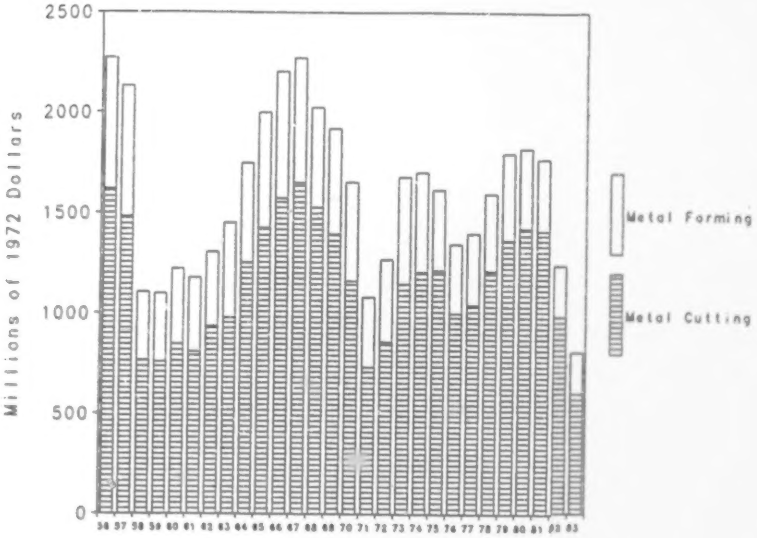


Year-to-Year Change in
Real Net New Orders of Machine Tools
1957-1982

Source: NMTBA 'Economic Handbook of the Machine Tool Industry, 1982-83' and NMTBA 'Industry Estimate of New Orders, Cancellations, Shipments and Backlog' (monthly).

Figure 3

Shipments of Machine Tools
by U. S. Builders
(1972 Dollars)
1956-83 (a,b)

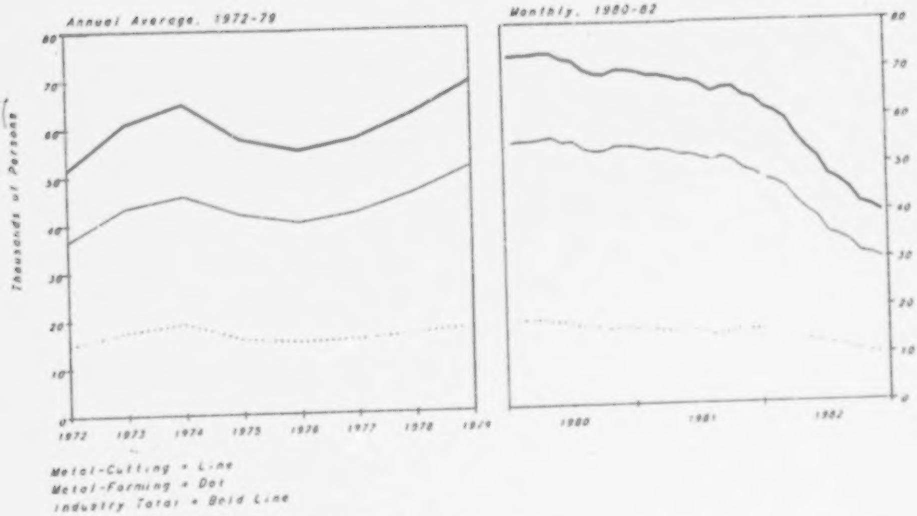


Source: U. S. Department of Commerce, 'Current Industrial Reports, Series MQ-35W, Metalworking Machinery.' Adjusted using BLS Producer Price Index for respective sector, re-based to 1972=1.00

(a) 1982 estimated using 3rd quarter figures for 4th quarter.
(b) 1983 forecast based on '1983 U. S. Industrial Outlook', U. S. Department of Commerce (1983).

Figure 4

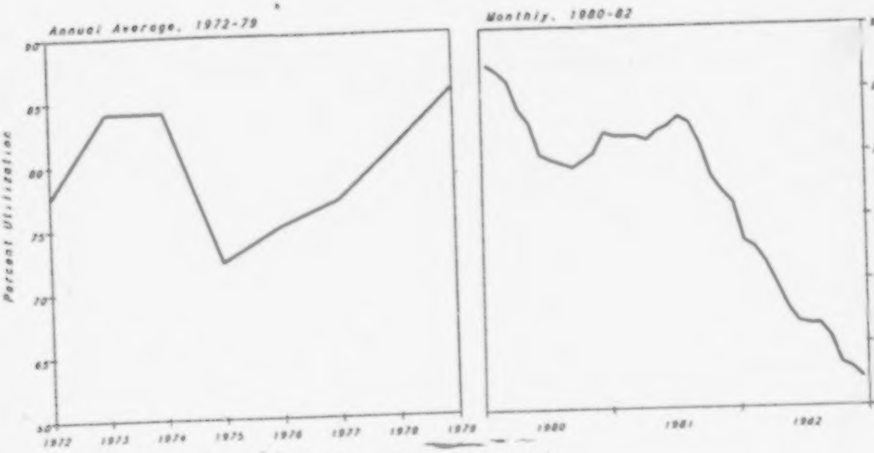
Employment of Production Workers in the Machine Tool Industry (Thousands of Persons) 1972-82



Source: U. S. Department of Labor, Bureau of Labor Statistics, "Employment and Earnings" (monthly)

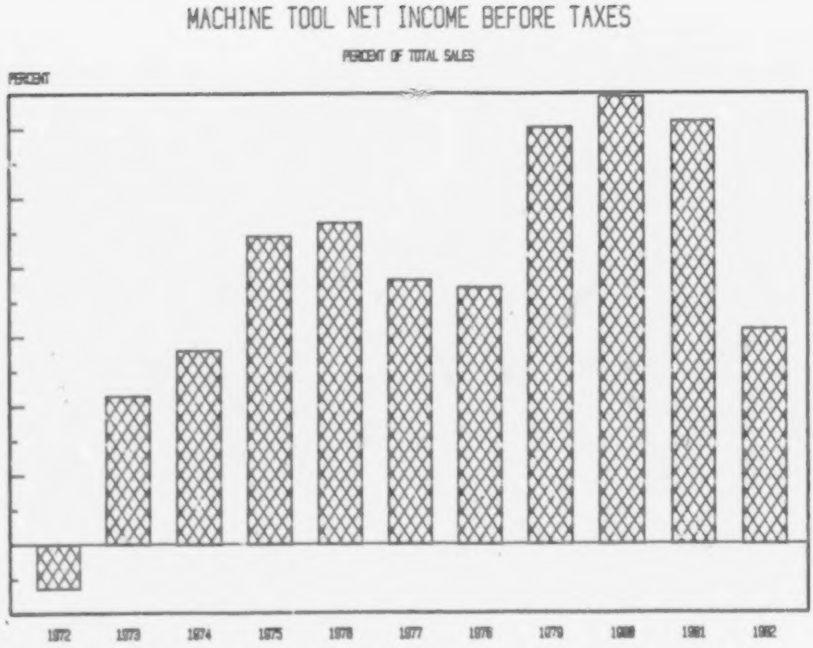
Figure 5

Capacity Utilization
in the Nonelectrical Machinery Industry
1972-82



Source: McGraw-Hill Publications Company, Department of Economics, 'McGraw-Hill Operating Rates Report' (monthly)

Figure 6

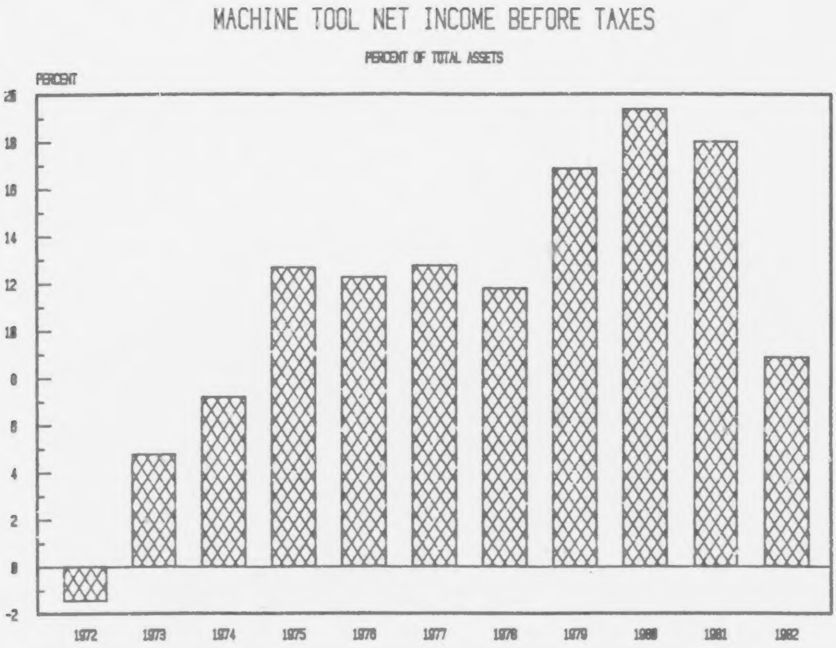


MACHINE TOOL NET INCOME BEFORE TAXES

PERCENT OF TOTAL SALES

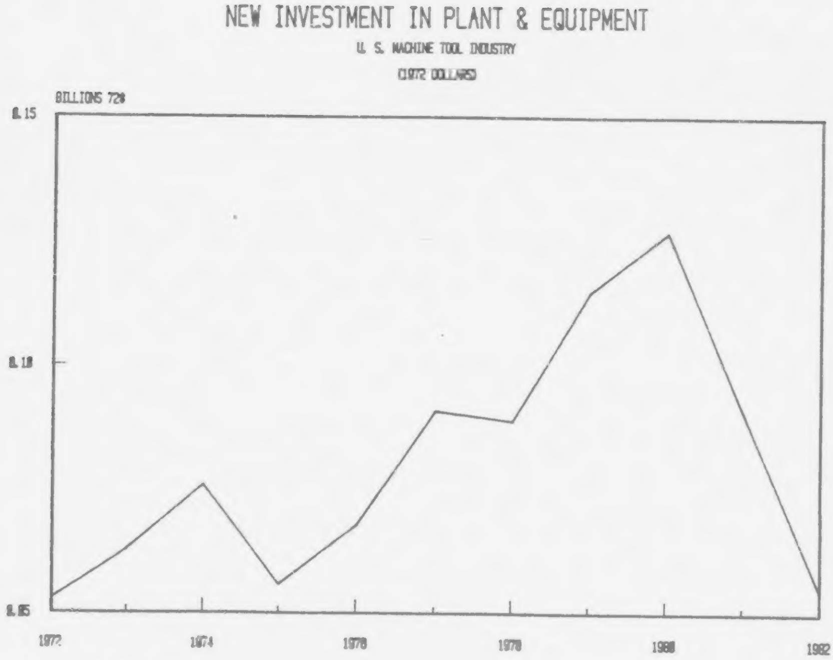
SOURCE: NMTBA "Economic Handbook of the Machine Tool Industry 1982-83," p. 255; 1982 projection by Data Resources, Inc. (1983).

Figure 7



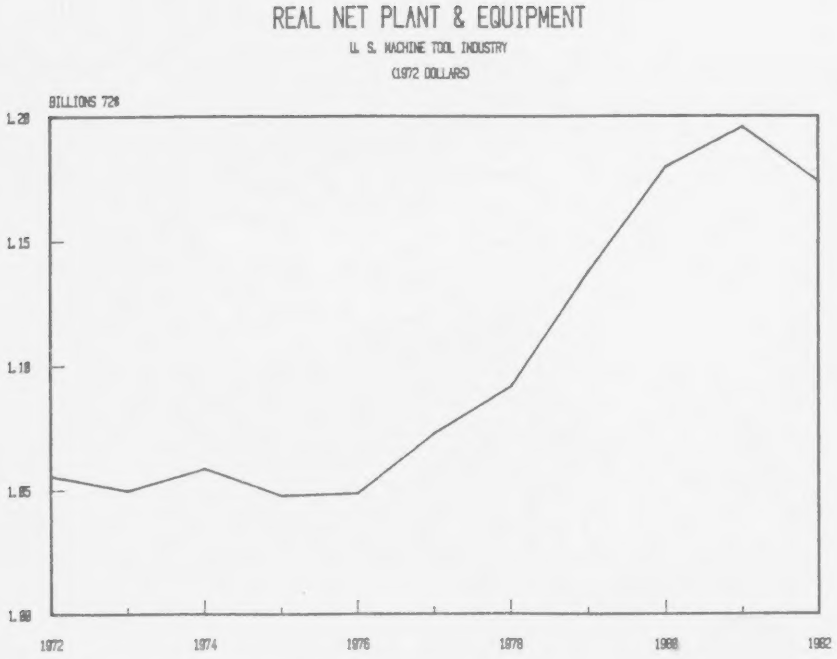
SOURCE: NMTBA "Economic Handbook of the Machine Tool Industry 1982-83," p. 255; 1982 projection by Data Resources, Inc. (1983).

Figure 8



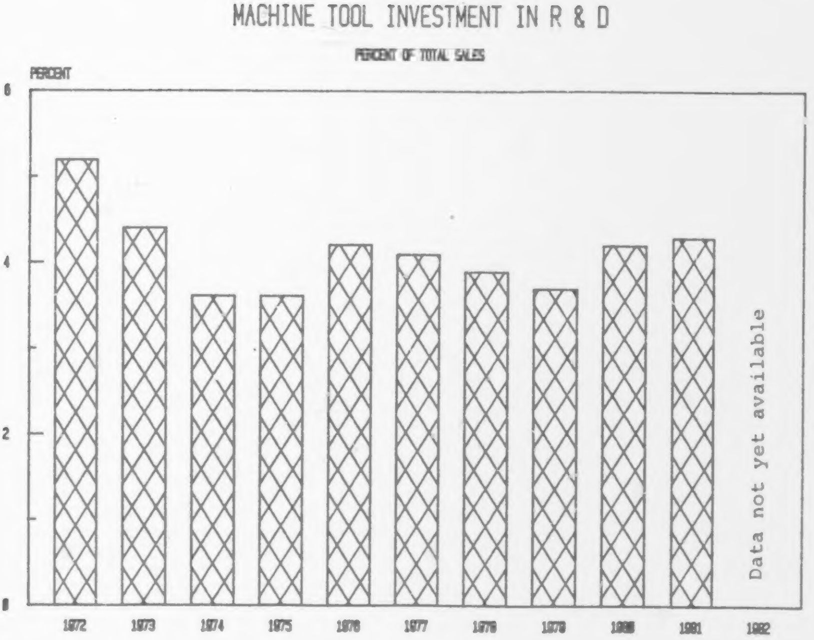
SOURCE: Data Resources, Inc. (1983).

Figure 9



SOURCE: Data Resources, Inc. (1983).

Figure 10



SOURCE: National Machine Tool Builders' Association, "Confidential Financial & Operating Ratio Report."

Mr. MITCHELL. Thank you very much, sir.

Now to our last witness, who has been so enormously patient: David Smith is vice president and treasurer of the National Association of Home Builders. Thank you for being with us.

TESTIMONY OF DAVID SMITH, VICE PRESIDENT AND TREASURER, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. DAVID SMITH. Thank you.

Mr. Chairman, members of the subcommittee, my name is David Smith. I am a homebuilder and developer from Germantown, Md.

I am testifying on behalf of the more than 118,000 member firms of the National Association of Home Builders, of which I am vice president and treasurer. The NAHB is a trade association of the home building industry, our Nation's largest small business industry. Of our members 52 percent build fewer than 10 housing units per year and 71 percent of our members build less than 25 units. I am pleased to be here to testify on the effects of the economic policy on small business.

Mr. Chairman, in your role on this committee, as well as the Banking Committee, we appreciate that you have been particularly sensitive to the challenges facing the homebuilding industry in recent years.

Currently, all indicators show that housing continues to lead the recovery. Housing starts in January were 15 percent above December's rate and 17 percent above the rate of 1 year ago. January's rate of 1,915,000 units was the strongest January in 11 years.

This level of production can be attributed to several factors, including healthy permit levels in the last several months, improved home sales, relative stability in interest rates, an abundance of mortgage money, and growing consumer confidence.

In December 1983, the unsold inventory declined to 302,000, or 4.5 months of inventory at current sales rates, the lowest since July 1971.

The housing industry led economic recovery throughout 1983. Although investment in housing only accounted for about 3.4 percent of the Nation's real gross national product in 1983, housing was responsible for 30 percent of the total economic growth, or for $15 billion of the $50 billion real increase in real GNP experienced during the year.

A production increase of 641,000 homes in 1983 from the prior year created 924,000 man-years of employment, $18 billion in wages and $8 billion in local, State, and Federal taxes. The first year of the housing recovery pumped $86 billion in new activity into the economy.

We expect the housing recovery to continue throughout 1984, with levels of activity comparable to those of 1983. However, even a relatively slight upward movement in interest rates could jeopardize the recovery because mortgage rates remain just at the threshold of affordability for significant numbers of prospective buyers. Further, it remains questionable whether the recovery can continue beyond 1984 if, by then, annual Federal deficits are still at their current annual level of about $200 billion. Economists are almost unanimous in their opinion that outsized Federal deficits will inevitably clash with the capital needs of private borrowers, drive up interest rates, and abort the recovery.

As we testified before the Budget Committees, we support a bipartisan effort to deal with the Federal deficit and we strongly support focusing on the issue this year. But we are concerned that a bipartisan down payment on the deficit will not go far enough.

Mr. Chairman, we homebuilders and the home-buying public understand all too well the meaning of "down payment." Let me caution you, as we advise our buyers, that a low down payment will serve only to increase this Government's "monthly payments." As a result, young families and the poor will once again be priced out of the opportunity for homeownership and decent housing unless interest rates are reduced. Since a 10-percent down payment is reasonable in the real estate business, I propose that the administration's fiscal year 1985 budget be reduced by 10 percent, or $92.5 billion, through spending reductions and tax increases, if needed. It is absolutely essential that Congress and the administration act now in a bipartisan manner to reduce the Federal deficit.

As to the specifics needed, NAHB urges the Congress and the administration to adopt the operating premise that spending cuts and tax increases should be as broad based as possible. On the revenue side, they should strive toward investment neutrality, not shift the relative attractiveness of capital from one economic sector to another.

NAHB has endorsed the proposal by Representatives Jones and Campbell to reduce cost-of-living adjustments and income tax indexing. NAHB also endorsed the general elements of last year's Senate Finance Committee deficit-reduction package which included an energy consumption tax, a surtax on high income individuals, and a corporate surtax.

Under any circumstances, spending cuts should be made along with tax increases to prevent taxes from being increased without comparable spending reductions.

Another area of spending which needs to be examined is the overall domestic discretionary budget and the defense budget. As former President Gerald Ford stated during a debate on the deficit before our recent annual homebuilders convention in Houston, there exists no reason why 5-year defense contracts cannot be stretched to 6 years as a means of addressing the deficit.

In summary, we realize Congress and the administration cannot eradicate budget deficits overnight. We also agree that the economy continues to improve and our own forecasts for housing construction for 1984 look very favorable. However, we know better than most major industries the impact of interest rates on sustained long-term growth. Having undergone the most severe recession since World War II, we are now leading the recovery. But until the deficits are dealt with by this Congress and the administration, this recovery cannot last.

Thank you for the opportunity to present our views. We stand ready to assist this committee and its staff in any way that we can.

[Mr. Smith's prepared statement follows:]

PREPARED STATEMENT OF DAVID SMITH, VICE PRESIDENT AND TREASURER, NATIONAL ASSOCIATION OF HOME BUILDERS

My name is David Smith, and I am a homebuilder and developer from Germantown, Maryland.

I am testifying on behalf of the more than 118,000 members of the National Association of Home Builders, of which I am Vice President and Treasurer. NAHB is a trade association of the nation's home building industry. I am pleased to be here to testify on the effects of economic policy on small business.

This Committee and its competent staff have been particularly sensitive to the challenges facing the homebuilding industry in recent years with your recognition that this industry is one of the largest and most important "small business" industries in the country.

STATUS OF THE HOUSING INDUSTRY

Currently, the figures show housing continues to lead the recovery.

Building permits climbed 41 percent in January to a rate of 1,772,000 units, the highest level since July 1983. All regions except the northeast registered increases from December with particularly strong gains registered in the north central (30%) and in the west (19%). The actual number of permits also increased between December and January.

Housing starts in January were 15 percent above December's rate and 17 percent above the rate of one year ago. January's rate of 1,915,000 units was the highest monthly rate since December 1978 and the strongest January in 11 years. All regions except the south, which dropped only minimally, registered increases in their starts rate over last month.

This strong performance can be attributed to several factors, including healthy permit levels in the last several months, improved home sales, stability in interest rates, a growing use of adjustable rate mortgages, an abundance of mortgage money, and growing consumer and builder confidence in the economy.

Sales of new single family homes jumped dramatically in December 1983 to a rate of 808,000 units, up 29 percent from November and the highest monthly rate since October 1978. Sales for 1983 were up a record high of 52 percent from 1982. All regions registered large increases from one year ago.

The new unsold inventory declined in December after 8 months of increases. In December 1983, the unsold inventory stood at 302,000 or 4.5 months of inventory at current sales rates. The month's supply at the current sales rate in December was the lowest since July 1971 when it stood at 4.1 months.

ECONOMIC RECOVERY

The present economic recovery can be characterized as primarily a housing-led recovery.

The following facts about housing's role in the economic recovery should be considered.

The housing industry led economic recovery throughout 1983. Although investment in housing only accounted for about 3.4 percent of the nation's real gross national product in 1983, housing was responsible for about 30 percent of total economic growth, or for $15 billion of the $50 billion real increase in real GNP experienced during the year.

1983 was the strongest housing recovery year since World War II. The approximately 1.7 million homes started in 1983 was a 60 percent improvement from the 1.1 million unit annual production level of 1981 and 1982.

A production increase of 641,000 homes in 1983 from the prior year created 924,000 man years of employment, $18 billion in wages and $8 billion in local, state and federal taxes. The first year of the housing recovery pumped $86 billion in new activity into the economy.

Consequently, it is vital to a sustained recovery that any future tax legislation enacted by Congress be as broad-based as possible and not disproportionately biased against housing. As illustrated below, rental housing is an important component of housing starts, and any changes which would curtail current tax incentives for multifamily housing would have a dramatic effect on this segment of the market.

HOUSING STARTS

	1981	1982	1983[1]	1984[2]
United States total starts	1,084.1	1,062.3	1,703.1	1,754.2
Percent change	−16.1	−2.0	60.3	3.0
Rental apartment starts	221.0	258.8	359.0	345.6
Percent change	−20.8	17.1	38.7	−3.7
Subsidized	112,700	114,200	34,700	5,600
Nonsubsidized	108,300	114,600	324,300	340,000
Total	221,000	258,800	359,000	345,500

[1] Estimate based on preliminary data.
[2] NAHB forecast.

Source: NAHB Economics Division, Feb. 2, 1984.

Tax benefits are a major means of making multifamily projects workable from an investment point of view. This is particularly the case since direct expenditures for housing programs have been virtually wiped out. For example, new program activity under HUD assisted housing programs has declined from $26.7 billion in fiscal year 1980 to $6.2 billion proposed by the Administration for fiscal year 1985. Virtually none of the funds proposed for fiscal year 1985 would be available for new construction or substandard rehabilitation.

Tax benefits, therefore, often become a deciding factor in determining the feasibility of a new project. Rental income, particularly for low and moderate income units, often does not cover debt service. The ability to utilize tax benefits through limited partnerships to attract investors is a critical element, if not the major deciding factor, in initiating a rental project. Drastic changes in rules for partnership allocations and the "at risk" provisions would sharply curtail this economic activity, thereby jeopardizing the overall economic recovery.

RECESSION AND HOUSING

The effect of the prolonged recession in housing, over a period of three years, has had a severe impact on the firms that produce construction materials. A large number of plants have been closed, many permanently. Capacity to produce most construction materials is less now than in the late 1970s. Nevertheless, serious and widespread shortages for most construction materials are not expected in 1984. We are experiencing shortages and significant price increases in gypsum wallboard particularly along the Eastern seaboard and in the Carolinas. In addition, our monthly Builders' Economic Council (BEC) survey for January 1984 shows some spot shortages of structural steel, roofing, windows, doors, insulation, brick, cement, millwork and lumber.

BUDGET

As we testified before the Budget Committees, we support a bipartisan effort to deal with the federal deficit and we strongly support focusing on the issue this year. The concept of the President's downpayment on the deficit does not go far enough, however.

Mr. Chairman, we home builders and the homebuying public understand all too well the meaning of "downpayment." Let me caution you, as we advise our buyers, a low downpayment will serve only to increase this government's "monthly payments." As a result, young families and the poor will once again be priced out of the opportunity for homeownership and decent housing unless interest rates are reduced. Since a 10 percent downpayment is reasonable in the real estate business, I propose a target downpayment of $92.5 billion in reductions to the Administration's FY '85 budget.

Our members feel so strongly about the budget and the resulting deficits that NAHB has embarked on a national, grassroots campaign to develop a broad consensus for action, a program which uses the theme that the federal deficit is America's "Ticking Time Bomb." As a result of this increased awareness among NAHB's membership and leadership that federal budget deficits impact negatively on sustained economic growth and the continued health of this nation's economy, we support action now, not in 1985. We support enactment of spending reductions as well as tax increases as needed to reduce the unprecedented $200 billion deficits.

To illustrate our members' commitment to action on the federal deficit, I wish to share with you some of the results of a survey conducted in January of this year by our Builders Economic Council.

When asked "what should be done about the federal budget deficit" a resounding 98 percent of the total favored "cut domestic spending" and 72 percent of the total favored "raise taxes." Sixty-eight percent of those interviewed favored a combination of "cut spending" as well as "raise taxes." Only four percent favored the option of "do nothing, the economy's growth will close the deficit." Further, four percent favored "raise taxes" only, and 25 percent favored "cut spending" only.

On the issue of tax increases, 43 percent of those favoring increased taxes support an increase in the corporate as well as the individual tax structure, 39 percent favor "sales" taxes, and 23 percent favor a "user fee" tax.

OUTLOOK FOR THE HOUSING INDUSTRY

We expect the housing recovery to continue throughout 1984, with levels of activity comparable to those of 1983. However, even a relatively slight upward movement in interest rates could jeopardize the recovery, because mortgage rates remain just on the threshold of affordability for significant numbers of prospective buyers. Further, it remains questionable, whether the recovery can continue beyond 1984 if, by then, annual federal deficits are still at their current annual level of about $200 billion. Economists are almost unanimous in their opinion that outsized federal deficits will inevitably clash with the capital needs of private borrowers, drive up interest rates, and abort the recovery. One reason for this is that at any given time during 1983, the federal government was borrowing half of the total credit available in the U.S. financial system, compared to only about 30 percent in 1980, 20 percent in 1970 and 5 percent in 1965.

THE DEFICIT AND TAX REVENUES

It is absolutely essential that Congress and the Administration act now in a bipartisan manner to reduce the federal deficit. Otherwise, we will be heading into a recession in 1985 and 1986. Certainly, that would not be the time to raise taxes or cut spending.

NAHB urges Congress to go beyond consideration of a small down payment on deficit reduction. NAHB recommends that the fiscal year 1985 Administration's $925 billion budget be reduced by 10 percent or $92.5 billion in fiscal year 1985, through a combination of spending cuts and revenue increases, if necessary. Tax increases should focus upon an across-the-board approach instead of relying on closing so-called "loopholes."

Otherwise, the economy may not be able to sustain the growth necessary to continue to finance the government. Deficits in the out-years could reach $300 billion, according to the latest CBO baseline projections. Despite the generally optimistic figures on housing starts and unemployment, the underlying health of the economy remains fragile. NAHB's housing affordability index, of which interest rates are a major factor, has shown a downward trend, evidence that potential home buyers are now being priced out of the housing market. A delay until 1985 postpones resolution of the problem until mid-1985 at the earliest. This would push collection of any new taxes and spending restraints into 1986. Such a delay could very well be too late and will continue to perpetuate uncertainty during the period of the delay. The time bomb is indeed ticking, and the clock is approaching midnight.

We are now six months into FY '84. Fiscal year 1985, the crucial year, will begin in October 1984. This timing necessitates action immediately if out-year deficits are to be sent on a downward trend.

As to the specifics needed to bring the deficit down, NAHB urges the Congress to adopt the operating premise that spending cuts and tax increases should be as broad based as possible. They should be fair in the sense of broadly affecting all income levels and sectors of the economy. On the revenue side, they should strive toward investment neutrality—i.e., not shift the relative attractiveness of capital from one economic sector to another thereby altering the present mix of investment options.

NAHB has endorsed the Danforth-Boren, Jones-Campbell "de-indexing" proposals. NAHB also endorsed the general elements of the Senate Finance Committee deficit-reduction package of 1983 which included an energy consumption tax, a surtax on high income individuals, and a corporate surtax.

On the spending side, concepts such as reducing the non means-tested cost of living adjustments (COLAs) have a great deal of merit. Revisions, such as a delay of three to six months of COLA increases, should be considered. If the Congress deems that it is not politically possible to revise the Social Security program, they should turn to other entitlement programs, particularly Medicare. The spending cuts should be made concurrently with tax increases to prevent taxes from being increased without commensurate spending reductions.

Another area of spending which needs to be examined is the overall domestic discretionary budget and the defense budget. As former President Gerald Ford stated during a debate on the deficit before our recent annual Home Builders convention in Houston, there exists no reason why five year defense contracts cannot be stretched to six years as a means of addressing the deficit. He believes rather fervently that such action would not place our national defense at risk. Since it remains no secret as to President Ford's position on defense issues, such a proposal for moderating these defense expenditures deserves careful consideration.

In seeking to develop a tax package for 1984, NAHB urges Congress avoid changes which are designed to raise revenues through relatively minor changes affecting various sectors of the economy. This approach, which was employed in 1982, could, instead of raising revenues, jeopardize the incentives for economic growth which are a part of the tax code. We should continue to provide incentives to save in order to strengthen the capital base necessary for investment which is vital for sustained economic growth.

For individuals, proposals to cap the mortgage interest deduction or other tax benefits for housing would have a devastating effect on the housing market. On the business side, tax increases affecting real estate would accentuate current biases against business investment in real estate. One measure which has received attention is a lengthening to 20 years of the depreciation period on structures. Currently, structures have a depreciation period that is three times longer than equipment. To increase the disparity to four times would be highly detrimental—pushing capital away from high risk investment in residential rental projects.

CONCLUSION

In summary, we realize Congress and the Administration cannot eradicate budget deficits overnight. We also agree that the economy continues to improve and our own forecasts for housing construction for 1984 look very favorable. However, we know better than most major industries the impact of interest rates on sustained long-term growth. Having undergone the most severe recession since World War II we are now leading the recovery, but, unless and until the deficits are dealt with by Congress and the administration this recovery cannot last. The ticking "time bomb" is real.

Thank you for the opportunity to present our views. Indeed the future of this industry and the overall economy is in the hands of Congress—along with the Administration and the FED—in the next few months. We stand ready to assist this Committee and its staff in any way we can.

Mr. MITCHELL. We thank you.

We will now go into questions, and I will hold very strictly to the 5-minute rule, including its application to the chairman, so the staff will keep time.

Mr. Browning, let me say first of all that in terms of your recommendations, generally the Small Business Committee is either in agreement with them or has done something in an attempt to further those recommendations already. For instance, we did introduce our small business participating debenture bill, which died aborning. We will try that again. Obviously, you heard our discussion about the possible use of pension funds.

I would be unfair to myself if I didn't say that the statement you made causes me a little bit of disturbance, and I'm just going to touch on it. You indicated that there should be no reason why people should expect they would get something for nothing from the Government, that they ought not be looking at the possibility of—I'm not using your words exactly—of a handout.

I take a little exception to that, particularly with reference to the Federal role in supporting small businesses and minority businesses. Just as you, Mr. Gilbert, have had to deal with some things that are beyond your control, some of these companies have to deal with things that are beyond their control. I don't think they come in to participate in a bank loan because they want to outfox a competitor. I think it's because there is just a necessity for them to do that.

Mr. **Browning**. Well, let me clear it up. Like so many things in communications, as business consultants we find many people think the idea is I'm going into business on OPM, "other people's money." This happens quite often, in which an individual has the entrepreneurial spirit but somehow they think that either the Government or the bank should provide them the money. They have no equity. There are times when you simply cannot go into business.

So I mention many times that everything is relative. A $5,000 commitment by one individual may be a bigger personal commitment than $50,000 to another type of person.

Mr. **Mitchell**. Thank you. I think there was a problem in communication.

You are recommending, among other things, that there be a general training and retraining business tax credit program enacted. We did that, and you alluded to it. We offered an incentive for businesses to train people—I forget under what act it was. It is my impression that it was a dismal failure.

Mr. **Browning**. Are you referring, Mr. Chairman, to the 1977-78——

Mr. **Mitchell**. That's right.

Mr. **Browning**. Well, I am not sure that the statistics would call it a failure. I can tell you this. Since we do operate nationally, a national program takes more than 2 years to implement. One of the things that we found, it was unbelievable the number of people that just woke up and heard about it as it was expiring, a tremendous number. So I would urge the committee——

Mr. **Mitchell**. You're saying the same approach would work if we give it more time?

Mr. **Browning**. If you took 1977 and 1978 and did it exactly the same way, give it 5 years—and don't try to implement a national program in 2 years, you cannot get the word out. We found many, even accounting firms and law firms that are involved in doing taxes, that oftentimes overlooked it in 2 years time, just communications. It is unfortunate, but it takes a lot of time to get a program like this going.

It was my understanding that the statistics showed it was successful, but I think if you had more than 2 years time, you would find a much different situation.

Mr. **Mitchell**. I think many Members of Congress would state it was not successful. I would be in agreement, that maybe we need more time to make it work. Unfortunately, there is a kind of mood, at least in the House of Representatives, that is focusing in on 1-year funding, guys who are saying, "Look, there's a danger in spreading these programs out."

I think I would agree that that program might be tried again and given more time. I would suggest that there is a real political difficulty, because of the climate we experience right now, in getting that done.

Mr. **Browning.** If the figure which a witness had earlier given here, which I had also in my notes, of $30 billion for each 1 percent or $1 million, if that $30 billion is true—and I don't understand for the life of me why the Treasury would oppose it, with that kind of payoff—that the cost would be perhaps $3 billion, if you can get back $30 billion for $3 billion, it doesn't take much beyond a sixth grade level to figure out that that might be a good investment. I don't quite understand the reason for not pushing it.

Mr. **Mitchell.** We are not in disagreement on that point.

Congressman Daub.

Mr. **Daub.** Thank you, Mr. Chairman.

It is an interesting point to analyze because, indeed, it's about $22 billion if you really objectively analyze all the trailing data. You might stretch it from $28 billion to $30 billion if you add the taxeater instead of the taxpayer while unemployed from the transfer payments that are absorbed. Just like it's interesting to note that while the actual cash payment to those poverty line or below is down slightly in the last 3 years, the actual nontaxed, nonappropriated moneys, like commodities that are being given away and things like that—which I prefer to be given away, by the way—are up substantially. So the net transfer payment in total to those below the poverty line is up very substantially in terms of aggregate billions of dollars from our Treasury.

So I think the other part of that is they do not send or descend in increments of 1 percent, 2 percent, 3 percent. You do not get $60 billion for 2 percent; you do not get $90 billion for 3 percent. So you have to be careful how you assert that 1 percent employed or unemployed affects the Treasury. It is not necessarily arithmetic, it's normally astronomic character in credit and capacity.

In the conversation about equity, I was engaged by the statement by Mr. Browning as well. I think that fair truth-in-lending regulations and the Fair Credit Reporting Act, all these things took the character out of what goes on in our process in terms of encouraging other people to be providers of credit and take some risk along with the entrepreneurial idea.

In your case, regulation 8(a), the set-aside program that you talked about, do you have MESBIC's in Detroit and are they turning you down for money?

Mr. **Dumas.** Well, they are not doing things in construction.

Mr. **Daub.** I attended a hearing with John Conyers, our colleague, and did a small business hearing at the chairman's pleasure in Detroit a couple of years ago and talked to them about the MESBIC activity. In our town the MESBIC activity is helping our contractors, particularly now with the anticipation of the 5-cent surface transportation increase and the 4-R programs that will be there. We think there might be some pursuit there, that you might encourage them to relook or rethink their opportunities to finance you because of that.

I don't think I had much else in terms of the witnesses' testimony, Mr. Chairman. I appreciated the testimony.

The machine tool business has been particularly difficult in my town. You know, if we don't have the railroads relative to the potential for national defense, if we don't have a strong economy, then I don't think we can have a strong defense. If we don't have tool and diemakers, if we don't have the skill for the kind of work that you do in this country, we're going to be in big trouble some day. Even though that workplace is changing to robotics and other kinds of functions, we really need help there.

I guess in the first instance I would say I wouldn't think 10 or 12 years ago you would ever have wanted a quota on anything, but now you evidently have come to the conclusion that it's the only way to preserve that industry base in the country.

As to the last witness, the homebuilders, I just finished addressing the homebuilders State meeting just the day before our chairman was in Omaha, as a matter of fact. I want you to know that they are really impressed by the opportunity to see that start figure go over $2 million this year. I want to point out to you that there is one problem, and that is the 10-percent down payment that you talked about Government making. You know, you can 100 percent conventionally finance houses now, too, and maybe that's a part of the problem as well.

Mr. DAVID SMITH. You've got to make the payments still, you know.

Mr. DAUB. I think sometimes the Congress delivers back to the American people exactly what it wants, and that's maybe a big problem, in that there are no down payments on anything any more and come on in and we'll take care of you.

Thank you, Mr. Chairman.

Mr. MITCHELL. Congressman Hayes.

Mr. HAYES. My first comment and question is directed toward Mr. Browning. It is obvious that we have a basic philosophical difference and I don't think one could convince the other within a 5-minute timespan. I just want to mention the fact that you did say that entrepreneurs have created the wealth in this country, but you failed to mention one main ingredient which I am concerned about. It takes people also to produce that wealth. I just want to make that comment.

You also mentioned in your partial listing of solutions as it relates to financing methods. You advocated an investigation by the administration and the Congress of allowing small firms to borrow from pension funds, which, is in part, an answer to the question raised by Mr. Dumas and the legislative counsel, Ms. Andrea Mack.

You said with adequate security. I want to know who makes that kind of measurement because I think this may be the reason for some of the difficulties that minority businesses have had as expressed by some of the other people here.

Mr. BROWNING. I think as long as you have an arm's length transaction with separate people acting as trustees, that as long as there is an arm's length relationship, I think the safeguards will be there.

Mr. HAYES. You are conscious of the fact that it has been testified to here that even though there are instances where many minority people contribute to those pension funds, yet minority small business does not have access to those funds. I think sometimes we ought to take a serious look at this whole area.

I'm through, Mr. Chairman.

Mr. MITCHELL. Mr. Luken.

Mr. LUKEN. Mr. Chairman, Mr. Gilbert's testimony raises some questions with reference to the subject matter here, which is the effect of economic policy on small business. He suggests that there are national security issues involved—and he's not the only one. There are obviously national security issues involved. If our machine tool industry is decimated, if we don't have an industrial base to produce the sinews of war, no one can question that.

But it does have a relationship to the effects of economic policy because our national security is, in fact, threatened in other ways by our economic policies that we're following, as has been testified to here. If we have $200 or $300 billion deficits on into the future, this nation is going to be severely weakened. We're going to have a bloated dollar and then maybe the bottom will fall out or something. We can't tell exactly what the cataclysmic results will be. All we know is they will eventually occur and we'll have inflation and high interest rates simultaneously and therefore will be a greatly weakened nation.

So Mr. Gilbert's testimony does apply to the industrial base or the defense base of this country. But overall, the testimony here generally affects the national security.

I might mention, getting back to the machine tool industry, because Charlie has testified to it and because it's so important in our area, the President made a decision last year on the Houdaille Co., which produces machine tools, and devised the stratagem of going to the government on a law which prevented the endowment of the investment tax credit on businesses which were guilty of certain practices. Without stretching out what those practices were—this is competition, of course. Houdaille took the case because of Japanese competition. The Japanese competitors who had taken the Houdaille process and manufactured machines, brought them here and targeted the industry, provided unfair collusive kinds of competition. A statement of agreed facts went to the President stating all these things, and yet the President refused to act. So it isn't only the Congress that can take action here, but it is the administration, not only the President but our trade representative and others.

Mr. Gilbert, with regard to the machine tool industry—since I have taken so much time, I would like to ask you one further question, at least one on the subject. You have testified as to the dramatic drop in production here in this country and the results of the increasing share of the imports. Is that due to the fact that the Japanese have a better technical product, that they have better technology?

Mr. GILBERT. No, I don't believe it is. I don't think most U.S. machine tool builders would agree that it is. In fact, there is on the public record an acknowledgment from the Japanese industry that they are behind the U.S. industry in technology and also behind the German industry in technology.

I think it has been established by a number of surveys that the penetration in the U.S. market by the Japanese has been occasioned principally by price. The low prices have been accomplished through various Government subsidies that the Japanese have. These things have been documented in the Houdaille petition and by work Houdaille did in Japan.

Mr. LUKEN. If we tried to do that in this country, we would violate all kinds of antitrust laws and other Government policies, wouldn't we?

Mr. GILBERT. Yes, we would.

Mr. LUKEN. So it's obviously unfair competition.

I take it, then, from your testimony—and I think my time is about up—that even if we did the economic things to correct the balance in our trade deficit, that wouldn't totally solve the problem in view of the practices of some of the companies such as in the Houdaille case; would you want to comment on that?

Mr. GILBERT. We mentioned in our full statement that one of the big problems is further investment in this country by machine tool builders and by large companies who have a choice of where they're going to put their investment dollars. We have seen already many machine tool builders and conglomerates start to procure complete machines overseas and, in fact, have engineering and distributing organizations for machines produced abroad. That trend is picking up and we have seen a number of machine tool companies' plants liquidated in this country and capacity established overseas. We're going to see a continuation of this which, of course, weakens our entire industrial base.

In our own case, we're a small company and under normal circumstances we employ about 170 people. We are in negotiations right now for bringing certain components in from overseas. People our size are doing that. You can see the seriousness of the situation because it is far easier for a big company, with a large organization, to establish that kind of a step than it is for somebody like us.

Mr. LUKEN. I thank you, Mr. Gilbert. I don't have any further questions, except to comment that this is the Small Business Committee and we are an advocacy committee in some respects, in some of the aspects of the matters we consider. But all of the members are members of other committees—I'm a member of the Energy and Commerce Committee—and I can assure you that your comments with reference to trade and commerce are ones that I will take over to the matters before the Energy and Commerce Committee, and I am sure the other members will, too.

Thank you, Mr. Chairman.

Mr. MITCHELL. Thank you. I thank all the members of the committee for being with us.

Let me tell you gentlemen, I have served almost 13 years here in this body and I think I understand that some of the feelings that witnesses have when they come before this committee, is it worth it; is anybody listening; will it pay off in results? I just wanted to share with you that whatever I have accomplished legislatively in the Congress is due in large part to the testimony that people have given me.

Now, I would feel that is true of many other members. It doesn't fall on deaf ears. The big problem is that it takes a little longer to implement. I just wanted to indicate to you that you have given us much work to do.

I just turned to our staff person to start following up with Chairman Perkins on the training bill. Others have indicated they are going to take action and initiate actions through their other committees on which they serve

I thank you for being here. Don't ever get the idea that it doesn't pay off. It does.

Mr. DAUB. Will the chairman yield?

Mr. MITCHELL. Very briefly, yes.

Mr. DAUB. I thank the chairman for his willingness to yield briefly. My intention would be to second what you said and say that, in fact, most of the ideas I have seen occur come from people with the hands-on experience, be it in the domestic, national, or international marketplace, and that we in Congress particularly hunger for those ideas because we're not really out there in the hands-on daily affected problem areas that you see and bring to us. So we hope that this is a two-way street. We listen to what you say and can, over a period of time, as frustrating as it may be, accomplish something as a result of your efforts. We do appreciate them.

Mr. MITCHELL. Just to illustrate the point further, we're going to follow through on that Surface Transportation Act, the difficulty that you're having, no question about it.

Thank you all very much for your patience and participation.

[Whereupon, at 1:50 p.m., the subcommittee adjourned, to reconvene subject to call of the Chair.]

APPENDIX

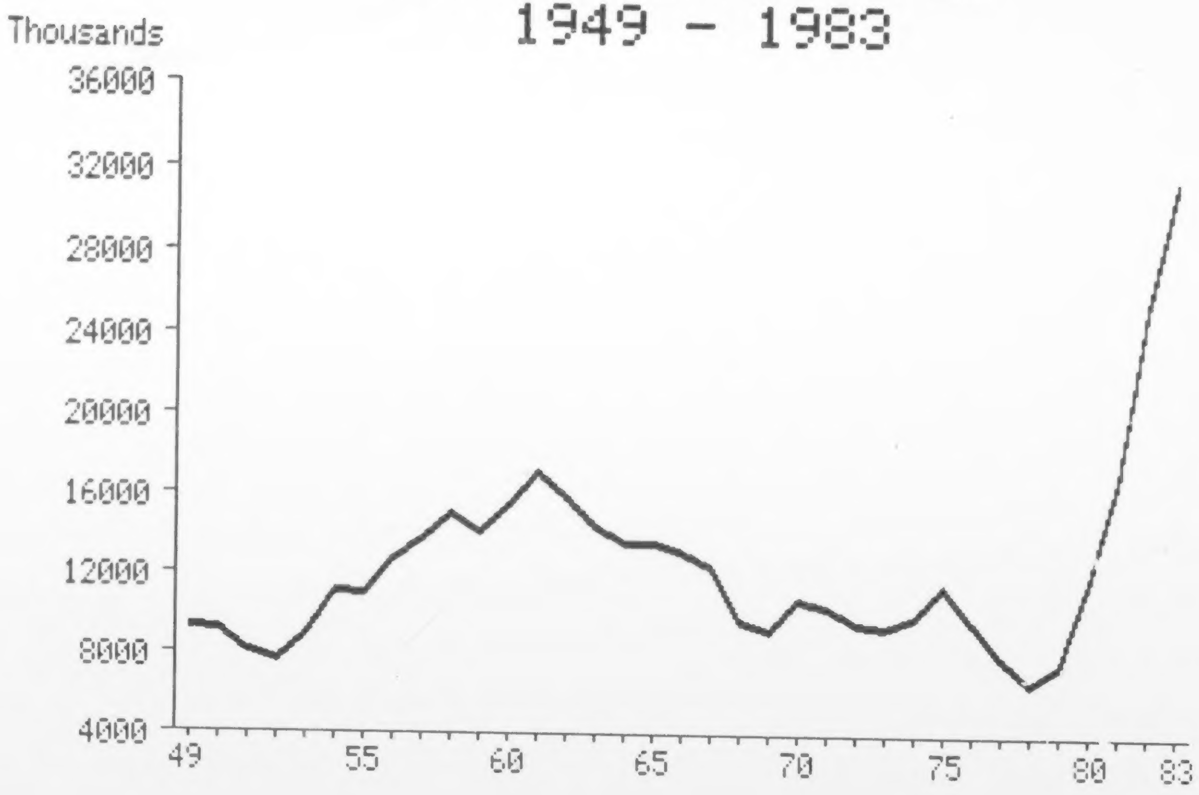
EMPLOYMENT, FOREIGN TRADE, INTEREST RATES, AND BUSINESS FAILURE TABLES

Total Civilian Employment 1/

Year & Qtr	Millions Employed	Percentage Change
		1st qtr to 1st qtr over 4 year periods.
1949 I	58.1	
1953 I	61.8	6.4%
1957 I	64.1	3.7%
1961 I	65.7	2.5%
1965 I	70.2	6.8%
1969 I	77.2	10.0%
1973 I	83.8	8.5%
1977 I	90.4	7.9%
1981 I	100.3	11.0%
1985 I*	105.8(w) 106.6(c)	5.5% 6.3%

1/ Source: U.S. Department of Labor
(w) Wharton Econometrics Forecasting Associates, April 1984.
(c) Chase Econometrics, April 1984.

Business Failures
1949 - 1983

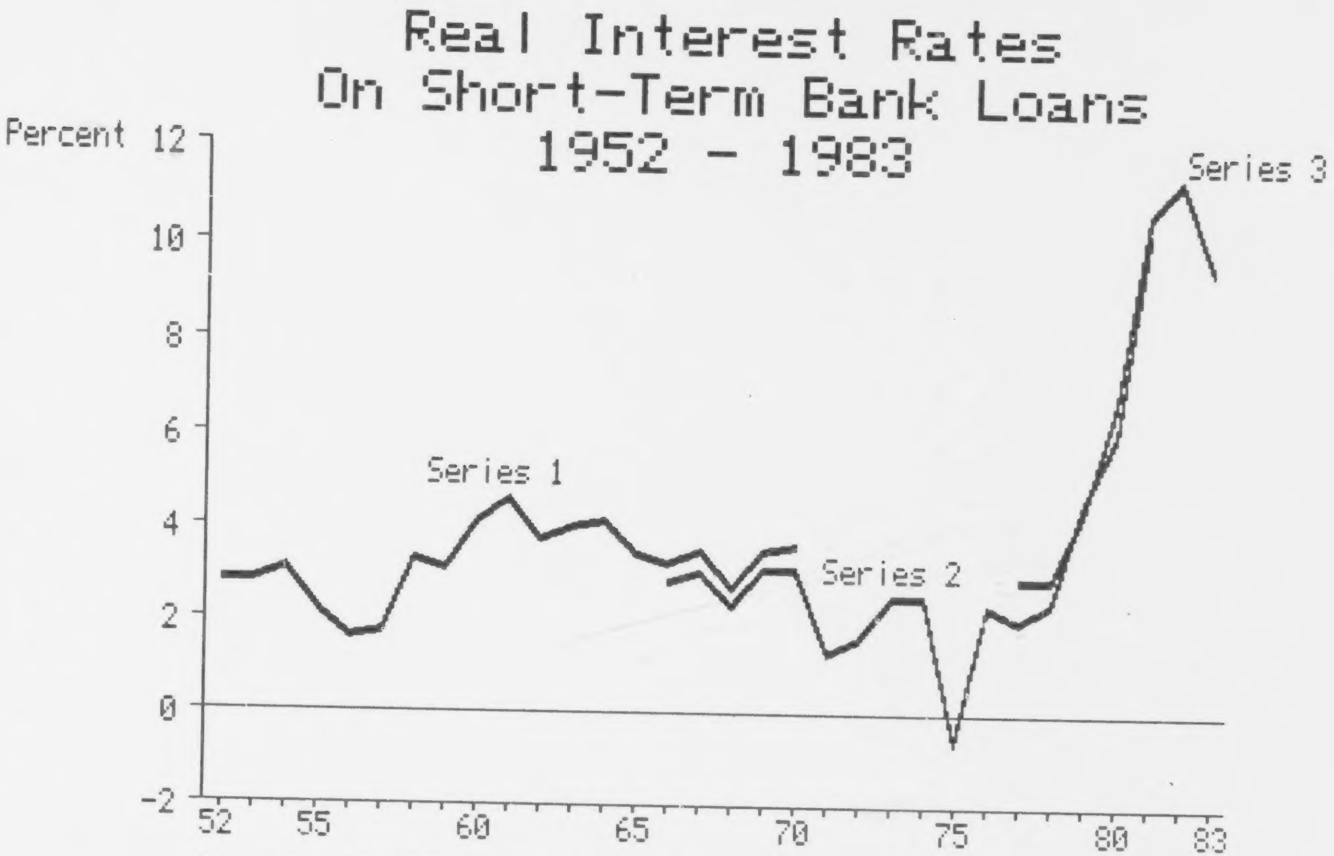


Source: Dun & Bradstreet Business Failure Reports

BUSINESS FAILURES: 1920 - 1983
(Dun & Bradstreet Reports)

YEAR	NUMBER
1920	8,881
1921	19,652
1922	23,676
1923	18,718
1924	20,615
1925	21,214
1926	21,773
1927	21,146
1928	23,842
1929	22,909
1930	26,355
1931	28,285
1932	31,822
1933	19,859
1934	12,091
1935	12,244
1936	9,607
1937	9,490
1938	12,836
1939	14,768
1940	13,619
1941	11,848
1942	9,405
1943	3,221
1944	1,222
1945	809
1946	1,129
1947	3,474
1948	5,250
1949	9,246
1950	9,162
1951	8,058
1952	7,611
1953	8,862
1954	11,086
1955	10,969
1956	12,686
1957	13,739
1958	14,964
1959	14,053
1960	15,455
1961	17,075
1962	15,782
1963	14,374
1964	13,501
1965	13,514
1966	13,061
1967	12,364
1968	9,636
1969	9,154
1970	10,748
1971	10,326
1972	9,566
1973	9,345
1974	9,915
1975	11,432
1976	9,628
1977	7,919
1978	6,619
1979	7,564
1980	11,742
1981	16,794
1982	25,346
1983	31,334

Real Interest Rates On Short-Term Bank Loans 1952 - 1983



Source: Series 1 - FRB, Business loans of $10,00-$100,000.
Series 2 - BCD, Business loans of all sizes.
Series 3 - FRB, Business loans of $25,000-$49,000

Nominal and Real Interest Rates on Short-term Bank Loans to Business*

Year	Series 1		Series 2		Series 3	
	Nominal	Real	Nominal	Real	Nominal	Real
1952	4.2%	2.8%				
1953	4.4	2.8				
1954	4.3	3.1				
1955	4.4	2.2				
1956	4.8	1.6				
1957	5.1	1.7				
1958	5.0	3.3				
1959	5.5	3.1				
1960	5.7	4.1				
1961	5.5	4.6				
1962	5.5	3.7				
1963	5.5	4.0				
1964	5.6	4.1				
1965	5.6	3.4				
1966	6.4	3.2				
1967	6.5	3.5				
1968	7.1	2.7				
1969	8.6	3.5				
1970	9.0	3.6	8.5	3.1		
1971			6.3	1.3		
1972			5.8	1.6		
1973			8.3	2.5		
1974			11.3	2.5		
1975			8.7	-0.6		
1976			7.5	2.3		
1977			7.8	2.0	8.7	2.9
1978			9.8	2.4	10.3	2.9
1979			13.2	4.6	13.0	4.4
1980			15.2	6.0	15.9	6.7
1981					20.0	10.6
1982					17.3	11.3
1983					13.7	9.5

* All loans are of less than 1 year in maturity. Real rates are the nominal rates minus inflation as measured by the implicit GNP deflator.

Sources:
Series 1. Federal Reserve Board, business loans of $10,000 - $100,000 Banking and Monetary Statistics, Table 12.8.
Series 2. Business Conditions Digest, business loans of all sizes.
Series 3. Federal Reserve Board, Business loans of $25,000 - $49,000, Survey of Terms of Bank Lending, Table 1.

Interest rates by loan size are not available for the period 1971 through 1976.

Balance on Merchandise Trade
(Billions - Current Dollars)

Year	Amount	Year	Amount
1960	4.9	1973	0.9
1961	5.6	1974	-5.5
1962	4.5	1975	8.9
1963	5.2	1976	-9.5
1964	6.8	1977	-31.1
1965	5.0	1978	-34.0
1966	3.8	1979	-27.6
1967	3.8	1980	-25.5
1968	0.6	1981	-28.1
1969	0.6	1982	-36.4
1970	2.6	1983	-60.6
1971	-2.3	1984	-114.0*
1972	-6.4		

*Based on trend in first quarter of 1984 -- a deficit of - $28.5 billion. Source: U.S. Department of Commerce.